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CONDITION OF THE SECURITIES INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

TO

EXAMINE THE STRENGTHS AND WEAKNESSES OF THE SECURITIES INDUSTRY AS WE ENTER A PERIOD IN WHICH THE COST OF CAPITAL AT HOME AND THE DEMANDS FOR CAPITAL HERE AND ABROAD, AND TO IMPROVE WHAT MAY BE A CUMBERSOME, INEFFICIENT AND ANTICOMPETITIVE REGULATORY SYSTEM FOR BANKS AND SECURITIES FIRMS, AS WELL AS RATIONALIZING THE REGULATORY SYSTEM FOR STOCKS AND STOCK INDEX FUTURES AND RELATED PRODUCTS

MARCH 6, 1990

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CONDITION OF THE SECURITIES INDUSTRY

TUESDAY, MARCH 6, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10 a.m. in room SD–538, Dirksen Senate Office Building, Senator Dodd, (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Sanford, Wirth, Garn, Heinz, D'Amato, Kassebaum, and Pressler.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The subcommittee will come to order.

Let me welcome everyone here this morning to our hearing on the condition of the securities industry. I want to thank the witnesses on our two panels for taking time out of very busy schedules to discuss the overall condition of the industry today as we enter the 1990's. I want to also express my gratitude to Senator Heinz and to welcome Senator Garn, who has over the years had a great interest in these issues.

Senator Heinz and I scheduled this hearing several months ago, and the dramatic events of recent weeks have made it an even more timely hearing. We've seen the failure of a securities firm which only a few years ago was the most profitable major firm in our country. Two other top ten firms have announced the need for large capital infusions, and a few days ago the rating agencies lowered the credit ratings of yet another major firm.

Layoffs in the securities industry are announced almost daily. A total of some 40,000 people have lost their jobs in the industry since 1987.

Some would suggest that, if the economic outlook is bleak, perhaps more disturbing is the diminishing public confidence in the securities industry. They point to the insider trading scandals, the so-called leveraging of America, and the heated takeover battles of the 1980's, stock market volatility resulting from new trading strategies and the exodus of individual investors.

Critics suggest that the securities industry of the 1980's was driven by fees, to the detriment of the public. Thus it has been noted that few people shed tears when Drexel failed, and the public has shown little sympathy for the current problems of the industry more broadly.

I believe that everyone on this committee agrees that the United States has the strongest, the fairest, and the most efficient securities markets in the world. That is in no small measure due to the creative genius and drive of the individuals who make up the securities industry in this country.

At the same time, we recognize there are problems—excesses, as some have suggested, and I think we all have to be concerned that those excesses could undermine public support for this vitally important industry. We have to debate those problems publicly and we have to look for ways to improve the securities industry and the financial system in which it operates so that it continues to be the remarkable capital-raising mechanism that has served this country so well for so many years.

This morning we hope to examine the strengths and weaknesses of this industry as we enter a period in which the cost of capital at home and the demands for capital here and abroad are a major public concern. I would note that just as we will have many questions for our witnesses this morning, the four witnesses on our first panel are not letting us off easy. They have challenged this committee and the Congress with a major agenda for action, improving what they view as a cumbersome, inefficient and anticompetitive regulatory system for banks and securities firms, as well as rationalizing the regulatory system for stocks and stock index futures and related products.

These issues pose tough political challenges for those of us on this side of the dais, but we simply cannot delay addressing them any longer.

I certainly appreciate the fine testimony of the witnesses and I look forward to having a very productive morning with all of you.

Let me turn to the ranking minority member, Senator Heinz, and to any other of our colleagues who care to make opening statements before we hear from the witnesses.

OPENING STATEMENT OF SENATOR HEINZ

Senator Heinz. Mr. Chairman, I want to commend you on holding these hearings. How you knew that they were going to be so timely may be a matter for SEC investigation. In any event, I commend you on your foresight and understanding that such hearings would be appropriate in any event. I do join you in welcoming today's distinguished witnesses as our subcommittee takes what you might call the pulse of the securities industry.

I use the term pulse because according to the charts of the 1980's the industry's vital signs look about as volatile as the stock market. During the bull market, many of our securities firms went on a binge, feasting on commissions from record high stock market volumes and stuffing themselves with fat fees as corporations gobbled each other up in a frenzy of merger and acquisition activity.

All that changed on Black Monday when the stock market dropped a record 508 points in one day and now we find that the securities industry is on (what you might call) a "crash" diet.

Huge overhead expenses, and large payrolls seem to be clogging the arteries that carry revenues down to the bottom line in that industry.

Wall Street firms have shed thousands of employees that they can't carry and firms are looking to trim those operations that are making their financial figures look unattractive.

The goal obviously is to be lean and mean in the race to be in first place in a very rapidly developing global marketplace.

Now from the standpoint of this subcommittee, while the securities industry gets itself in shape, it's our responsibility to focus on certain activities that appear to have put the industry at high risk. Obviously, Drexel's sudden demise is a warning that high capital levels are not sufficient to ensure good health.

Liquidity is the lifeblood of the securities industry and confidence is critical to survival. I am concerned that many firms are hooked on a steady diet of risky activities that may result in losses that become difficult to digest even for the most healthy firms. If the trend continues the term tombstone may take on a new meaning on Wall Street.

There are other serious conditions that may need treatment. The individual investor is still traumatized by the 1987, the 1989 stock market crashes and spooked by stock market volatility. Building investor confidence in our markets is essential to the securities industry's long-term health.

The current regulatory system, it seems to this Senator, is also in dire need of a checkup and may also be a candidate for radical surgery. We need to create an environment that enhances competition and ensures the stability of our financial system. But most importantly, we've got to develop a system that immunizes the taxpayers from the risk of loss.

Mr. Chairman, a strong securities industry is vital to the health of our economy. They are the vehicle by which entrepreneurs, large and small, raise the capital they need to build and grow America. These firms dispense the funds that nourish those companies' growth and development. I hope that today's witnesses can provide us with the right prescriptions.

Senator **Dodd**. Thank you very much, Senator Heinz.

Senator Sanford, do you have an opening statement?

OPENING COMMENTS OF SENATOR SANFORD

Senator **Sanford**. Thank you very much. I certainly thank our very distinguished panel for being here and look forward to their testimony.

I would like to put this entire statement into the record and simply say that the past few weeks have proved again that the economic situation in the country is not all we thought it was; there are a great many dangers lurking out there.

I was struck by the testimony of Jerome Kohlberg presented to this committee just last Firday. As you know Mr. Kohlberg is one of the early pioneers in leveraged buyouts, yet he spoke forcefully about the decade of excess in the 1980's, particularly excesses in fees paid to a host of market players, excessive conflicts of interest among those who put together deals, finance those deals trade in the shares of those deals. Certainly coming from that source, that was a very striking assertion.

I certainly want to commend our witnesses for their forthright calls for restructuring of the financial services industry. I agree with Mr. Gutfreund that it's time for us to get to it and we look forward to getting to it with this testimony and in the coming weeks.

[The complete prepared statement of Senator Sanford follows:]

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to thank our very distinguished panel of witnesses for their thought-provoking and somewhat troubling testimony.

The last few weeks have certainly proved to be interesting ones in the economic life of this country. I know all of us watched with considerable concern and interest as the once-mighty Drexel Burnham collapsed before our very eyes. Its fall raises a host of issues about the capital position of our investment banks and their broker-dealers, and the relationships between our banks, securities firms, the Federal Reserve and the SEC in situations in which any major market player is in jeopardy.

Last week, this committee held at hearing on the fall of Drexel and its implications for our markets. I was very struck by the testimony of Jerome Kohlberg, one of the early pioneers in the leveraged buyout movement, who spoke forcefully about the decade of excess of the 1980's—particularly excesses in fees paid to a host of market players and excessive conflicts of interest among those in market putting together deals, financing those deals and trading in the shares of the deals.

Indeed, while many have said the fall of Drexel marks the end of the debt-driven takeover and leveraged buyout era, I remain troubled that many of the abuses that we have witnessed during this "decade of debt" have not been taken care of, and that the drive to come up with new techniques to pick up the pieces of the deals that have gone sour or to continue to generate large fees remains strong. I think the Congress must take action to ensure that the excesses that Mr. Kohlberg spoke of are reined in immediately.

In order to do just that, last week my colleague Jim Sasser and I introduced legislation intended to stop the abuses we have witnessed in the past and are all to likely to see again in the future—deals done with little or no money at risk on the part of buyer, institutional investors participating in short-term trades on the speculation of a takeover, and management abusing its inside information to put together an LBO with little or no outside analysis or disclosure. I hope this committee will soon examine that legislation and the excesses of recent years to ensure that we, in addition to the market, put an end to abusive practices that only lead to a perception that the market is a rigged game for insiders.

I also want to commend our witnesses for their forthright calls for restructuring to our financial services industry. I certainly agree with John Gutfreund that it's time for us to get to it. We must be willing to examine critically the myriad of proposals to reform our deposit insurance system to ensure that savers have a safe place to keep those savings yet restoring some market discipline to our banks and thrifts. We also must address the problems associated with the dramatic shift away from individual investors toward institutional investors in the market. If our capital markets are to play the equity raising function that were designed for, we must ensure that all participants, including the small investor, find the market to be fair and efficient for everyone in the market.

This morning's hearing gives us to opportunity to focus on these and variety of issues that are critical to the long-term health and stability of our financial system. Again, I thank our witnesses for their thoughtful testimony and look forward to discussing a number of these issues with them.

Senator DODD. Thank you very much, Senator Sanford.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman. I particularly appreciate being here today. While not a member of this particular subcommittee, as you mentioned in your opening remarks, I have had some passing interest in restructuring and deregulation over the last 15 years, so I do appreciate the opportunity of being here.

Mr. Chairman, I would also like to commend you and Senator Heinz on another in your continuing series of hearings examining ways in which we can enhance the competitive position of the U.S. capital markets and financial service providers in the global arena. I am delighted to see that we have such an esteemed panel of securities executives here today to provide us with their perspectives on the condition of the securities industry and its role in the financial marketplace of the 1990's.

I would particularly like to acknowledge the presence of Phil Purcell, who, along with his father, I have known for many, many years. In fact, I knew his father a long time before I knew Phil and both of them are very distinguished Utahans. I'm pleased that you are here today, Phil.

Mr. PURCELL. Thank you very much, Senator.

Senator GARN. This morning's hearing is particularly timely in view of the turmoil in the markets over the past few months and especially given the demise of Drexel and reported problems of some other Wall Street firms. From what we know now in the Drexel case, it appears that the system worked remarkably well. The regulated broker-dealer is solvent. Customers will not lose any funds. The Government's interest is protected. It is the nonregulated affiliate which bore the direct risk.

While Drexel's demise demonstrates the fundamental strength and stability of our financial markets, it also reflects some of the problems. This is a difficult period for the securities industry, as the witnesses today will tell us, in the go-go years of the 1980's are giving away to a period of retrenchment and consolidation, as competition increases and profit margins narrow.

Rather than throw in the towel, however, and relegated our financial institutions to second-tier status in the global marketplace, it seems to me it's more important than ever that we craft an economic regulatory and legal framework which enables our financial service providers to weather current secular and cyclical difficulties and to be better positioned to meet the global challenges in the new decade.

We must modernize our financial services laws. I regret that I've been making that statement for 15 years and we have not yet seen fit to do that. I think the unfortunate thing as I go back and review some of the hearings of more than a decade ago, some of those hearings were rather prophetic. A lot of people who were told at the time, "Relax, sit back, this is not going to take place," if anything, they underestimated the speed of the change and the internationalization of the capital markets. And while we have been playing intermural games worrying about the S&L across the street or the bank or some securities affiliate, we have been losing the international competition.

So I make that statement very, very strongly, that more than ever I think what has taken place has proven the wisdom of some of us who have been trying to make those changes for a number of years and I repeat, we must modernize our financial services laws.

I am delighted to see that today's panelists recognize this fact. The SIA has made a constructive contribution with their initial proposal and I look forward to seeing their legislative language.

I also welcome John Gutfreund of Salomon Bros to the debate on financial services reform. I found his comments to be thought provoking and I look forward to his continued participation in this dialog.

Thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Garn.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, let me commend you for holding this hearing and also for being responsible for bringing to the table such an outstanding panel of witnesses. I am interested in hearing them and so I'm going to ask that my statement be submitted to the record as if read in its entirety.

Senator Dodd. Without objection, it will be so ordered.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I am pleased that we are able to meet with so distinguished a group of witnesses to discuss a most important subject. As you know I believe that America's investment banking industry is one of this country's primary assets toward insuring America's continued leadership in the global economy and the continued prosperity of our citizens. When we compare America's financial strengths with those of our competitors, our only real edge lies in the innovation and aggressiveness of our financial professionals. These are the fine minds that we must rely upon to respond to the myriad economic challenges and opportunities of our rapidly changing world.

I am pleased that today's witnesses address the need to stay competitive by reforming the legal and regulatory framework in a manner that protects both the individual investor and the taxpayers' pockets from the risks which inhere in the securities business. Clearly, this hearing is an opportunity to kick off a concerted effort to move legislation in the Banking Committee that strikes the proper balance between the two vitally important goals of preserving competiteness and insuring the soundness of the financial system.

It pleases me to know that Senator Riegle is in the process of organizing a series of hearings on financial modernization. With that initiative in mind, I will acknowledge the support of Mr. Purcell and Dean Witter for the Cranston-D'Amato-Garn Depository Institutions Affiliation Act. This bill is an excellent place to begin the process of insuring the continued health of the securities industry and the financial services industry as a whole.

Senator DODD. We again welcome all four of you this morning. We have your testimony and all of it will be included in the record as if read. You may want to paraphrase your remarks rather than go through the details of each prepared statement.

I will begin with you, Bob, as the chairman of the SIA, and then John Gutfreund, Phil Purcell, and, Mr. Simons, let you be the cleanup hitter as the regional representative. We welcome you. Bob Downey is the chairman of the Securities Industry Association and a senior partner with Goldman Sachs and an active participant in the discussion over the years in the range of issues affecting the securities industry. It's a pleasure having you before the committee, Bob.

STATEMENT OF ROBERT N. DOWNEY, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION

Mr. DOWNEY. Thank you, Mr. Chairman.

On behalf of the Securities Industry Association, I would like to thank the subcommittee for the opportunity to participate in these hearings on the condition of our industry.

I am Bob Downey, a partner of Goldman Sachs, an international investment firm. I am here in my capacity as chairman of the SIA. The Securities Industry Association represents over 600 firms active in the securities business. With me is Edward O'Brien, who is president of the association, right back here. You all know him.

We are large firms. We are medium sized. We are small. Some are exclusively retail. Some are regional. Some are investment bankers operating nationally and internationally. Some of our members try to do it all.

The subject of these hearings is the condition of the industry. We have described our recent difficulties at length in our written testimony and I will not do more than touch on them here. I believe a brief word about what the securities industry has accomplished in the past decade is essential to a perspective on the future.

The boom experienced in the capital markets until late 1987 was fueled in large part by creativity and drive on the part of the securities industry. The health of our industry and that of the capital markets are intertwined. If our capital markets are down, so is the industry.

There is no question that the industry is at a low ebb right now economically and, to some extent, in its public image. The fall of Drexel is, of course, on everyone's mind. A number of factors contributed to the Drexel bankruptcy, some unique to Drexel, others extreme versions of problems that afflict the industry as a whole.

While much yet remains to be known about this particular event, I would like to comment briefly.

The difficulties and collapse of Drexel should not obscure some positive achievements. The high yield securities which Drexel pioneered made financing available to many small companies that otherwise could not have accessed the capital markets. Like commercial paper, money market mutual funds, asset-backed and mortgage-backed securities, and a host of other instruments developed by the securities industry, the so-called junk bond in its proper time and context is an important and beneficial development in financing techniques.

As recently acknowledged by the Federal Reserve Board Chairman Alan Greenspan, high yield securities remain a legitimate and vital vehicle for companies to raise funds.

Drexel's demise is a reminder that the securities business in this case underwriting and dealing, is an increasingly risky one. Its character has changed markedly from the days when commissions were the lifeblood of the industry. Today, they account for less than 17 percent of our revenues. An increasing percentage of industry revenues comes from the principal transactions involving principal risk, as alluded to by Senator Heinz.

The Drexel incident also reflects how self-reliant the industry is. When Drexel could no longer stand on its own, it failed. The Government did not rush in to save it, nor should it have. This stands in marked contrast to what happens when federally insured banks fail.

The securities business is indeed risky, but potential failure does not trigger Government bailouts. In testimony just last week before the full Senate Banking Committee, SEC Chairman Breeden observed that taxpayers did not have to put out a single penny in the Drexel collapse. Senator Garn observed the same thing this morning.

What improvements are needed in the capital markets in the near future? The top priority must be restoring equities as a meaningful financing alternative. The volume of new public offerings of equity securities has dropped to a trickle since October 1987. Adverse individual investor reaction to the volatility in equity securities is not the only reason for this. The reality is that our tax laws currently make debt financing far more attractive than equity financing. The disincentives to equity investment must be addressed. The reestablishment of a preferential capital gains rate, the elimination of the double taxation on dividends, and expanding the use of IRAs would be a start. Mr. Chairman, you have long been an advocate of IRA's as an inducement to saving and we commend you on that.

A reinvigoration of our equity markets also requires efforts to minimize volatility and make the stock market attractive once again to the individual investor. As my colleague, Luke Simons, will note in his testimony, the retail investor, the backbone of this Nation's equity investment, has lost confidence in the system. The perception that the system is rigged against the individual must be eliminated.

It is true that index arbitrage can exacerbate natural volatility and create synthetic volatility and we all recognize that as a problem and condemn it. But unplugging the computers is certainly not the answer.

Because of the great concern of all, from program traders to regional brokers, SIA last December established a special committee, "The Action Committee on Market Volatility and Program Trading," to address these issues in depth. The committee's specific recommendations will be submitted to the SIA board next week. We hope the recommendations, if adopted, will help bring these investors back to the market. They are needed.

However, the single most important adjustment needed to deal with these concerns and harmonize the cash and futures equity markets is the establishment of the SEC as the single regulator of all equity and equity-related markets, a change which SIA and the industry as a whole strongly endorses.

We must also deal with the institutionalization of the markets as a fact of life. Proposed SEC rule 144(a) would make our markets more efficient and attractive to foreign issuers. The rule on the whole is a very positive development. However, the rule as proposed has disturbing implications for unfair competition between securities firms and banks. The concern is that rule 144(a) will provide a vehicle for commercial banking organizations to expand securities activities conducted directly within a bank. Such activity by a federally supported, federally insured bank that is not required to comply with broker-dealer requirements would put broker-dealers at a tremendous competitive disadvantage. It is our hope that before the rule is promulgated the SEC will revise its rule to limit the availability of the safe harbor in the context of commercial banking organizations to section 20 affiliates of bank holding companies which are registered with the SEC.

Looking to the future, the main concern for the industry must be its competitiveness. There are many complicated factors involved in keeping our domestic financial services institutions competitive with foreign institutions in the light of globalization and pressures for structural reform generated by EC 1992. Of course, our friends in the commercial banking business want to diversify and securities is at the top of their list.

At the same time there is a grave concern for placing more risk on the Federal deposit insurance system. The thrift disaster's cost of $200 billion or $300 billion—or whatever it is—to the taxpayer is in some part, perhaps the largest part, due to diversifications that continue to be backed by the Federal deposit insurance system. That is money that can't be used for rebuilding the Nation's infrastructure or reducing the deficit or helping the countries of Eastern Europe, Latin America, or Africa. The Nation cannot afford to make the same mistake twice.

However, even though Congress has not sorted through what it wants to do or how it wants to do it, banking regulators are proceeding on their own with securities powers for banks through regulation by loophole. Already five commercial banking organizations can underwrite and deal in junk bonds. Some of them are busily raiding Wall Street firms right now for junk bond traders, no doubt seeing the disappearance of Drexel as an opportunity.

Chairman Gonzalez of the House Banking Committee just last week had a letter delivered to Chairman Greenspan urging that the board not allow any equity dealing by commercial banking organizations until Congress had received the deposit insurance studies it has commissioned and come up with a new plan.

In testimony before that committee, Chairman Seidman of the FDIC agreed that expanded powers should not come before deposit insurance reform. We think that is wise counsel.

The need for international competitiveness, the need for fair and open markets at home, the need to increase investor protection and protection of the taxpayer are all critical considerations that must be dealt with together comprehensively because they are all interrelated. To that end, SIA 2 years ago put together a legislative policy committee to come up with a plan. I am pleased to say that all of the firms represented on this panel this morning—Salomon Bros., Dean Witter, J.C. Bradford and Goldman Sachs—participated in the development of the plan and in the unanimous vote of the SIA's board which adopted the approach last December.

Our approach is in our written testimony and I will comment only briefly at this time.

The cornerstone of the proposal is the creation of a new, nonfederally insured entity, an investment banking finance company, which could be established by bank holding companies. This new entity could engage in wholesale credit and depository activities and could interact fully with affiliates engaged in the wholesale securities and securities-related businesses. At the same time, the investment banking finance company and its securities affiliates would be totally prohibited, with very limited exceptions, to contact with any affiliated federally insured bank. This mechanism could permit banking and securities activities to be conducted within the same commercial banking organization without forcing the deposit insurance system to shoulder the securities risk and without triggering a too-big-to-fail status.

In effect, the Government is taken out of the competition altogether. SIA believes this proposal can serve to harmonize the divergent interest of the banking industry, securities industry, depositors, investors, and taxpayers. We are continuing to work on it and hope to have something quite detailed for consideration in the very near term. We look forward to working with the Senate Banking Committee and this subcommittee on the proposal and other matters of concern in the months and years ahead.

Thank you very much.

[The complete prepared statement of Robert N. Downey follows.]

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SECURITIES SUBCOMMITTEE
UNITED STATES SENATE

HEARING ON THE CONDITION OF THE SECURITIES INDUSTRY

March 6, 1990

TESTIMONY OF

ROBERT N. DOWNEY
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

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EXECUTIVE SUMMARY

The U.S. securities industry has a record second to none in evolving capital-raising mechanisms to fund corporate growth and public improvements. The industry has been, and continues to be, vital, creative and resourceful in creating financing alternatives. This creativity and focus on new financing opportunities are hallmarks of the industry and the reason that its survival and continued health are crucial to the nation's future.

However, after a prolonged boom in the past decade, the securities industry currently finds itself in a down cycle. Overcapacity in the aftermath of the October, 1987 market break has led to increased competition and low profitability. At the same time, a diminution in commission revenues as a source of income has brought about increasing reliance for profits on underwriting, merchant banking and other transactions involving principal risk. In addition, market volatility has increased greatly due to a variety of factors, including globalization of the financial markets; today's communications can quickly cause financial downturns to spread from one end of the globe to the other virtually instantaneously. For these and other reasons, the industry currently is experiencing a combination of high risk and low return.

The recent bankruptcy of Drexel Burnham Lambert's parent company illustrates both the problems and the strength of the securities industry at present. Drexel pioneered the high yield bond, thereby opening up financing opportunities to many small businesses that previously had no access to the capital markets. Because of recent overuse of leverage, the so-called "junk bond" has fallen into disfavor. But, in its proper time and context, the high yield bond has been a beneficial development for our nation's industries, like commercial paper, money market mutual funds, asset-backed securities, and a host of other financial vehicles developed by the securities industry as alternatives to what banks traditionally provide.

Drexel's failure demonstrates just how risky a business securities underwriting is. In Drexel's case, it sustained huge losses when its junk bond inventory suffered a precipitous drop in value, but such losses are possible with any of the increasing number of instruments securities firms take principal risk on, be they yesterday's investment grade debt that becomes a "fallen angel" or a highly-rated equity that suddenly is displaced by a competitor with a better product.

The demise of Drexel also illustrates one of the most important, and healthy, aspects of our existing securities industry, its self-reliance. The "survival of the fittest" doctrine that prevails in our securities industry, as demonstrated by Drexel's fate, stands in sharp contrast to the "too big to fail" doctrine that prevails in the federally insured parts of the financial sector. Contrast Drexel's downfall to that of the savings and loan industry. Whereas the cost to the American taxpayer of the federally insured thrift disaster will run into the hundreds of billions of dollars, Drexel's failure did not trigger a flow of federal support.

The nation needs to encourage savings. SIA supports the reestablishment of a preferential capital gains rate, the elimination of the double taxation of dividends, and other measures to restore investor incentives. The future health of our capital markets depends on measures to increase our distressingly low national savings rate.

Ending the split regulation between the equity and equity-related markets could be the single most positive step towards rebuilding confidence of individual investors; the single regulator should be the SEC.

In addition to the competitive pressures caused by current overcapacity, the securities industry faces heightened competition as a result of the increasing inroads by the banking industry into the securities business. While the securities industry is accustomed to, and does not fear, competition, it has much to fear from unfair competition from federally insured banks and the affiliates they support; the taxpayers has much to fear as well. The securities industry as it exists today cannot survive if forced to compete in the securities business on unfair terms with commercial banking organizations that enjoy federal support such as deposit insurance and open access to the Federal Reserve discount window, and with foreign banking organizations that enjoy their governments' support and subsidies.

The disappearance of a securities industry independent of affiliations with federally insured commercial banks, with its record of innovation and creativity, is but one possible adverse effect of the current trend towards financial services "diversification," if appropriate measures are not taken. An equally deleterious consequence of the increased participation in the securities business by federally insured banking organizations is that the containment of securities risk within the private sector that has been possible, as evidenced by the Drexel example, may no longer be possible.

One of the greatest challenges for the financial sector in this decade will be to develop a structure that reconciles the several apparently inconsistent objectives that are currently on the national agenda. These include (i) the critical one of reducing risk to the federal deposit insurance system; (ii) whether one thinks it good or bad, restructuring our existing system so that commercial banking organizations may participate more fully in securities activities; and (iii) making it possible for those securities firms that wish to concentrate on what they do best to continue to do so in an environment of fair competition, instead of being forced to merge into commercial banking organizations -- as happened in Canada a few years ago.

SIA is developing a proposal which it hopes will serve to harmonize the divergent interests of the banking industry, securities industry, depositors, investors and taxpayers. A cornerstone of the proposal is the creation of a new nonfederally insured entity, an investment banking financing company (IBFC), which could be established both by bank holding companies and by securities firms. This new entity could engage in wholesale credit and depository activities, and could interact fully with affiliates engaged in the wholesale securities business. At the same time, the IBFC and its securities affiliates would be totally prohibited, with limited exceptions, from contact with any affiliated federally insured bank. This mechanism could permit banking and securities activities to be conducted within the same commercial banking organization without forcing the deposit insurance system to shoulder the securities risks and without triggering "too big to fail" status.

Many other important issues involving the securities industry remain to be resolved. In particular, regulators are seeking more information about, and possibly greater supervision of, the currently unregulated parts of the holding companies of broker-dealers. The appropriate resolution of these and other issues as to the extent of additional regulation of currently unregulated entities depends in large measure on what restructuring of the current financial services system occurs, and on whether the success or failure of such entities can continue to occur without implicating the American taxpayer.

TESTIMONY

On behalf of the Securities Industry Association, I would like to thank the Subcommittee for the opportunity to participate in its hearings on the condition of the securities industry.

I am Bob Downey, a partner of Goldman, Sachs & Co., an international investment banking firm headquartered in New York City. I am here in my capacity as chairman of the Securities Industry Association. SIA represents over 600 firms active in the securities business. We are large, we are medium-sized, we are small. Some are exclusively retail, some are regional, some are investment bankers operating nationally and internationally and some of our members try to do it all.

I would like to first comment on some recent events of great significance as well as the general condition of the industry at present. Then I would like to review what I believe have been the benefits to the United States of a system providing securities intermediaries as an alternative to bank financing. Finally, I will outline the concerns I believe we should have in mind as we look to how the U.S. should reorganize its financial system for the years ahead in an ever more closely interconnected world. Appendix A to this testimony supplements with statistical information the discussion in this testimony about the growth of the industry in recent years and the difficulties now faced by the industry.

CURRENT STATE OF THE INDUSTRY

Any discussion of the state of the industry must begin with an acknowledgement that we are currently at a low point in what has always been a cyclical business. Our last major down period was in the mid-'70s when a combination of events, including the elimination of fixed commissions on stocks, plunged the industry into grim times. At that time there were many thousands of jobs lost and hundreds of companies failed or were merged out of existence. Today we are experiencing tremendous job losses and companies are failing.

It took the industry a long time to recover in the '70s but by mid-1982 a capital markets boom was underway and continued to late 1987. As volume and activity swelled, so did volatility and risk. The character of the securities business changed with the times. The commission business, the mainstay of the industry for decades and the safest part of the business, now constitutes less than 20 percent of industry revenues. Principal transactions, involving principal risk, mushroomed. The securities industry has long been known as an industry of risk-takers, but that term is more apt today than ever. It is a risky business requiring great skill and intense management. Even so, failure will occur, as the industry proves on a regular basis. The industry to a certain extent reflects economic conditions; often it is an advance indicator. But when a downward turn comes, it can come with a vengeance.

That is what happened in October 1987. The rumbles actually started a few months earlier in August, but the earthquake came on Black Monday. The biggest casualty then was E.F. Hutton, long one of the great names of Wall Street. But the aftershocks remain, and, within the past two weeks, we have had the biggest collapse of all with the parent company of Drexel Burnham Lambert filing for bankruptcy.

As business boomed in the early '80s firms added personnel and opened new locations. With individual investors deserting the stock market in substantial numbers after October 1987 and understandable caution taking over in many quarters, activity slowed and overcapacity quickly developed in the industry. With overcapacity an already highly-competitive business became even more so. Fees on transactions were slashed as diminishing business was fought over. At times there was no return in a deal at all as firms took business just to keep their personnel busy and to maintain market share.

The federal tax reform act of 1986 also contributed to the problems of the industry: municipal finance was badly hurt as state and local tax-exempt financing was restricted; preferential treatment of capital gains was eliminated; IRAs and other tax-advantaged retirement plans were cut back; and real estate investing lost its favored status under the tax code. As stock values of companies fell due to the slump in the market, takeover activity spurted with LBOs since asset values of companies remained high, many LBOs utilizing one of the newer financing devices, the high yield or so-called "junk bond."

Overcapacity in the securities business is being further aggravated by the entry of commercial banking organizations through loopholes opened up by bank regulators. In an industry already characterized by intense competition and extremely narrow margins, these new entrants, eager to gain market share, are forcing fees and spreads even lower.

As in the '70s, the securities industry has proven once again that "free to fail," the hallmark of private enterprise, applies to it. The industry is shrinking. Approximately 35,000 jobs have been lost in the last two years. It is estimated that another 15,000 jobs may be eliminated. Some firms are going out of business. A comparison of the leading firms of 15 years ago and today shows very well how free we are to fail. The strong and well-managed are surviving, the weak are not.

This is an industry that operates on its own. The government watches and helps us police ourselves, but it does not support us. Market discipline is harsh, but effective. The sad story of Drexel is but one, very large reminder. Actually, the demise of Drexel illustrates this healthy aspect of the U.S. securities industry. Drexel operated in the market and the market closed it down. No federal intervention took place and not one taxpayer dime was spent to save it. Drexel was big, but the "too big to fail" doctrine for large commercial banking organizations does not apply to securities firms not affiliated with commercial banking organizations. Uncle Sam is just a spectator and that is the way it should be.

The failure of Drexel also demonstrates just how risky a business securities underwriting is. In Drexel's case, it sustained huge losses when its junk bond inventory suffered a precipitous drop in value, but such losses are possible with any number of instruments securities firms take principal risk on, be they yesterday's investment grade debt that becomes a "fallen angel" or a highly-rated equity from a company that suddenly is displaced by a competitor with a better product.

Overcapacity and increased risk are only two of the issues of the day for the industry. While we do not have all the answers, it may be useful to recite some of the other important items:

- How do we deal with the blessings of the computer in the sophisticated world of program trading when not everyone has the same tools and skills? There are legitimate opposing views that are passionately felt. Nevertheless, when natural volatility is exacerbated by index arbitrage and thus creates synthetic volatility, all market participants agree that this results in a serious problem. The securities industry and the nation need those individual investors who have for now abandoned the market. SIA has a special committee hard at work hammering out a plan to bring individual investors back while preserving a free, efficient market. As Secretary of the Treasury Brady has observed, just banning the computer from the markets would be as senseless as outlawing the telephone would have been decades ago after the 1929 market crash. SIA hopes to put some guidelines before its Board of Directors at its March meeting that will help convince individual investors that the markets are not rigged against them.

- Can we continue to live with split regulation of important complementary equity and equity-related markets when in our hearts we know the public would be best served by a single regulator, the SEC? Perhaps the one most important step that could be taken to stabilize U.S. markets and to restore confidence in the markets would be this change.
- Will the SEC's Rule 144A create an undesirable two-tier market? Will commercial banking organizations be required by the SEC, as they should be, to operate on the same competitive basis as securities firms and carry on all of their Rule 144A and private placement activities in broker-dealers without using the resources of their own federally insured banks?

- What kind of regulation is sensibly required by government officials for the unregulated parts of a securities firm with no federally insured commercial bank affiliate? What is the most effective role for government regulators, what role works? Is greater control by government regulators the answer? Drexel failed, no tax dollars were put at risk. Continental Illinois was kept from failing at a cost to the federal deposit funds of billions of dollars; thrift failures have cost hundreds of billions of dollars. Is regulatory "control" of a business that deals in high risk possible in practice? At what cost?

- How do we protect the integrity, competitiveness, fairness and attractiveness of the American financial markets while other jurisdictions have less demanding regulatory frameworks? For example, we pride ourselves on the quality of our disclosure in this country, which gives confidence to many investors, yet some issuers desiring to disclose less may avoid our markets and go elsewhere.

- How do we fulfill what we believe is the principal mission of the securities industry, encouraging investment? While this Subcommittee does not have jurisdiction over tax policy, tax policy has a great deal to do with savings, investment and the health of this industry dedicated to helping to invest savings in capital projects and business. SIA believes the U.S. government should encourage private savings and investment with a preferential capital gains tax, elimination of taxation of dividends and by bringing back the IRA. Incentives work.

THE VALUE OF AN INDEPENDENT SECURITIES INDUSTRY

The current problems faced by the industry should not obscure its achievements in the past decade. The financial alternative provided by our industry we believe has been of enormous value to America. The action Congress took in 1933 to separate traditional commercial banking from the risk-taking of the securities industry has turned out to be an act of genius for capital formation in the United States and, beginning about 15 years later, in Japan. When one looks at the success of capital-raising mechanisms to fund corporate growth and public improvements, no country's record compares with that of the United States. Money has been raised and in the process ownership of corporate assets has been dispersed, entrepreneurship has flourished and consumers have benefitted from lower-cost goods due to lower-cost financing by the producers of goods.

The traditions of the United States have included diversity of financial choice and of discouraging concentrations of financial power; private sector financial markets; and the absence of governmental ownership of economic and financial institutions. These traditions have been good for America and the question now is whether we can continue them in the future. Instead of 10,000 commercial banks, should we have 100 or 50? Instead of 600 securities firms, should we have 20 or ten or five to compete in the world of tomorrow? Will an independent securities industry be able to survive and prosper? What will be the loss to America if the answer is "No"?

Let me give a few examples of the benefits of an independent securities industry as a competitive alternative. Commercial paper meant major corporations could borrow for two percent less than prime and pass the savings along to their customers. When post-Vietnam inflation skyrocketed and trapped the person with modest funds in his interest rate-controlled bank account, the money market fund came to his rescue and put him on a par with the very large CD buyer. When banks themselves were whipsawed by the same surge in inflation and wound up with fixed, low interest mortgages and increasingly costly short-term funding, the invention of the asset-backed securities market saved many of them. It helped them get back on an even keel and provided them with a way to keep giving their customers what they wanted -- fixed-rate mortgages -- while avoiding interest-rate shocks themselves by spinning the mortgages off into pools to be securitized.

There has been a great deal of negative comment recently about high yield securities. I would like to provide some balance. As Federal Reserve Board Chairman Greenspan recently testified before the Economic and Commercial Law panel of the House's Committee on the Judiciary, high yield securities remain a legitimate and vital instrument for companies to raise funds. The high yield securities which Drexel pioneered made financing available to many small companies that otherwise could not have accessed the capital markets. They were not merely instruments for the LBOs and other debt-financed restructurings that have received so much attention. Only a small fraction of all of the businesses in America can obtain an investment-grade rating. The rest have in the past been left with very limited options -- bank financing or no financing being the usual ones. Some of our current business successes were made possible in large part by high yield securities.

I hope these few examples make my point: had there not been a separate securities industry, banks would have continued to collect those extra financing costs from major corporations and more small investors would have buckled under the weight of post-Vietnam inflation. MCI might not have been able to grow as it did.

In the '80s capital markets boomed in the U.S., in Japan and in the off-shore Euromarket, overwhelmingly fueled by the creativity and drive of securities firms. By contrast, most of the capital markets of Europe were either moribund or just starting to stir. Could it be that the action of Congress in 1933 that led to separate securities industries in the U.S. and later in Japan was at least in part responsible? Some would say yes. When universal banks, as in Germany, can both lend and underwrite, it is a sensible bank that will lend at greater profit and forego the less profitable underwriting role or dealing in commercial paper.

Our industry has helped create the world's finest capital markets here in the United States -- liquid, open and honest markets. Despite our nation's tough disclosure requirements, many foreign companies come to America to raise money. Foreign investors have long flocked to our markets with a confidence they had nowhere else. We have fueled American entrepreneurship. We are a creative and inventive industry. We have developed financing alternatives that never would have existed if there had not been a separate, strong and independent securities industry. Without the competition of a separate securities industry, costs can be higher for borrowers and capital markets can be sluggish. And as a Merrill Lynch, a Morgan Stanley and a Salomon Brothers demonstrate every day, the securities and securities-related services that this nation requires can be handled competently free of any government backing.

In light of the contributions past and present of our securities industry, we must ask some challenging questions as we enter the '90s:

- Do we need, do we want to continue to have the benefit of, a separate securities industry in the United States?
- How can we allow our commercial banking organizations to participate in greater securities and securities-related activities without adding unacceptable risk to the federal deposit insurance system and American taxpayers or destroying the separate securities industry we have?
- Is the world so interrelated that we will have to conform our way of life in the United States to that of other nations and jurisdictions? Specifically, if the European Community allows universal banking, massive concentrations of financial power and ignores the subsidization of state-owned financial institutions, must the United States go along and abandon its history of

diversified financial power and a financial marketplace free of the dominations of government-owned or government-supported participants?

- What structure will replace the Glass-Steagall Act? The Glass-Steagall Act has been the order of the day in America from 1933 until 1987 when banking regulators started dismantling it on their own. Must not Congress act if it is to provide the kind of competitive situation and safety for taxpayers that the times demand? Only Congress represents the taxpayers and it is Congress that must raise money from taxpayers when regulatory actions go awry.

THE PRESSURES FOR UNIVERSAL BANKING

American commercial banking organizations claim that, for the United States financial services industry to compete with the Deutsche Banks of this world, the United States must adopt the universal banking model that soon will be available throughout Europe. While we do not necessarily agree that this form of organization is the only one, the best one or even a good one to emulate, we are realistic enough to understand that the political power of commercial banks and the perceived threat of EC '92 are pushing that option towards viability. Therefore, careful examination of the ramifications should be undertaken.

How successful has the universal bank been? It is claimed that without the "synergy" resulting from the ability to offer securities, banking and insurance services under one roof, the United States will become a relic in the world marketplace. While this argument may sound plausible, it ignores reality. There are three economic power blocks in the world today -- the United States, Japan and the European Community -- and together the United States and Japan, both of which have rejected the universal banking approach, dwarf the capital markets of the 12 European Community nations. The largest banks in the world are Japanese, even though they are subject to Article 65, which is patterned after the Glass-Steagall Act. Therefore, the size of those banks is due to other factors such as a high domestic savings rate, the rise in recent years of the value of the yen and, until recently, the soaring Japanese stock market.

The pressure to conform the American financial services system to the European system is not, of course, coming exclusively from U.S. banking organizations. Foreign banks and governments are making similar demands. Indeed, the initial draft of the European Community's Second Banking Directive conditioned access by U.S. (and other non-European) companies to the European Community single banking license on "reciprocity," meaning the United State must allow EC commercial banks to engage in the United States in whatever activities they are permitted to engage in at home, which of course includes securities activities. The banking directive was revised subsequently to require only "national treatment," i.e. no discrimination against European banks in the United States vis-a-vis domestic banks, but EC member nations and the EC Commission are urged to press the United States (as well as other nations) to reorganize as the EC is organized. (However, neither the McFadden Act nor the Glass-Steagall Act violates "national treatment" under the EC's Second Banking Directive, which is scheduled to go into effect on January 1, 1993.)

For European Community nations to adopt universal banking is of course their privilege. However, any attempt by the European Community to force the internal markets of the United States and Japan to conform to theirs is, to say the least, presumptuous. Each nation should be able to decide how best to organize its internal affairs and how to compete internationally. Each nation has its special considerations. In our case, our federal deposit insurance system and the rise of the doctrine of banks which are too big to fail complicate our situation tremendously.

While the European Community is an important financial marketplace, a little perspective may be in order. The United States and Japan together have the majority of the world's equity capitalization (72 percent as of December 29, 1989); the 12 EC member nations account for about 20 percent. If we are to change the U.S. financial structure, we should do so after our own careful deliberations, not because of pressures from foreign sources. We must decide for ourselves what makes sense.

There are many things to consider before we embrace universal banking German-style. Will the anti-competitive effects of such a system outweigh the alleged competitive benefits of "synergy"? The German model of universal banking has resulted in an oligopoly of financial institutions which has not distinguished itself for the creativity or multiplicity of its financing techniques and options. We have thousands and thousands of banks, thrifts and credit unions. We have hundreds of securities firms. In most European Community nations, there are only small numbers of financial institutions other than those engaged in home mortgage lending.

Also, Germany's small number of commercial banks are very closely allied to either the federal or state (e.g., Bavarian) governments. In France, three of the four top commercial banks are owned by the Republic of France. Credit Lyonnais and Banque Nationale de Paris are very active state-owned banks and their credit ratings reflect their government ownership. Therefore, they have advantages in borrowing costs as units of the state. Italy and Belgium also have banks with high credit ratings because of full or partial government ownership. The subsidies enjoyed by such state-owned banks are serious competitive advantages. It has been suggested that such subsidies of financial institutions be raised in dealings under GATT and with the European Community in the same way in which United States deals with industrial subsidies, e.g., such as lodging protests against the governmental subsidies of Renault and Airbus.

Some interesting questions arise. Is a securities subsidiary of state-owned Banque Nationale de Paris a fair competitor in the United States markets--or elsewhere? In the United States less than one percent of the economy is controlled by government-owned institutions; in France the figure is estimated to be somewhere between 30 percent and 50 percent. For the functioning of an international financial marketplace, must the American market or, for that matter, the Japanese market be open without adjustments for the subsidization of state-owned foreign financial institutions?

It is impossible for U.S. financial institutions to compete on equal terms with such government-owned banks unless the U.S. government stands behind and subsidizes every activity of our financial institutions. Yet it is absurd to think we would do this; the U.S. taxpayer has suffered enough through risk overload of the federal deposit insurance system. Rather than trying to emulate the Europeans, we should ensure that, whatever is worked out, to the extent possible, foreign governmental subsidies to European and other banks are eliminated, at least insofar as competition within the United States capital markets is concerned.

One other feature of the universal banking model merits comment. In Germany, commercial banks can invest heavily in the equities of industrial companies. It is well-known that Deutsche Bank owns about 30 percent of Daimler-Benz and directed the most recent change in top management. Bank representatives sit on the managing boards of many corporations. This is not a model that should have much appeal in the United States.

Clearly, there are many, many adjustments which will have to be made to fit a universal bank into our American structure should it be determined it is desirous to do so.

SECURITIES ACTIVITIES AND TAXPAYER RISK

In his introduction to President Bush's 1991 budget, Richard Darman warns of the $3 trillion contingent liability of the federal government and taxpayers with respect to banking and other organizations backed by the United States. The independent securities industry currently contributes not a penny to these frightening figures.

The exposure of the federal government to liability from securities and securities-related activities in general has been limited until relatively recently by the Glass-Steagall Act. Two developments have changed that situation. First, one securities-related activity in particular that was considered safe in 1933 -- dealing in foreign exchange -- has become a high-risk venture because of new volatility in the currency markets and the rise of speculative foreign exchange trading. Second, federal banking regulators have opened up gaping loopholes in the Glass-Steagall Act to permit securities activities by federally insured banks and by their subsidiaries and affiliates. Some affiliates of federally insured banks are now authorized to deal in junk bonds. Indeed, there is some indication that Drexel's collapse is being viewed by commercial banking organizations as a great opportunity -- they are now raiding Wall Street firms for junk bond traders.

Certainly, the securities industry is having severe problems. However, in the United States, the most significant development of the '80s in the financial sector was the stupendous collapse of the thrift industry. The cost to taxpayers is still being guessed at, with some estimates approaching $300 billion over and above what was set aside in the federal deposit insurance fund.

The solution propounded in 1982 to the problems resulting from the lifting of interest rate restrictions -- and adopted by Congress -- was diversification. A costly mistake. In a recent column, financial writer Bob Kuttner who also writes for Business Week noted:

> "The apologists blamed the S&L collapse on dependence on low-interest, fixed-rate mortgages, and on the government limitations on their freedom of action. But guess what: a comprehensive study by John Rickmeier, in the S&L-Savings

> Bank Financial Quarterly, found that the 'plain vanilla' savings and loans -- those which stuck to their knitting and pursued the traditional business of lending to homeowners, were the ones who best rode out the storm." The Boston Globe, February 16, 1990, 17.

The cost of the thrift bailout shows what happens when the risk-takers are backed by Uncle Sam. As observed in The Economist (December 2, 1989) by the reviewer of a study of the thrift disaster (Paul Zane Pilzer with Robert Deitz, Other People's Money, Simon & Schuster; 1989):

> "[The] blame lay not merely with . . . deregulation, but with the fact that Congress had deregulated only one side of the thrifts' balance sheets. They were given great freedom on the asset side in the sort of loans they could make or securities they could buy, while the risk of loss on the liabilities side, to those who had provided deposits, remained underwritten by the federal government. The result was a franchise tailor-made for gamblers and fraudsters. If they made money, thrift owners collected the profits. If they lost it, Uncle Sam ate the loss."

Since the '30s, securities firm failures have not resulted in taxpayer payouts. We should make sure that continues to be the case.

Nonetheless, we need to address what changes need to be made to accommodate "globalization." We know that many in Congress are torn: they are fearful of greater diversification for commercial banking organizations because of the thrift diversification disaster, but at the same time they are concerned about "international competitiveness." As recently as last week Senator Garn, the distinguished ranking minority member of the Senate Banking Committee, deplored the Congressional and regulatory failures which resulted in the huge thrift bailout but at the same time he called for diversification for commercial banks. Can these seeming inconsistencies be reconciled? SIA believes they can.

Whether Congress or the nation likes it or not, the banking industry already is a significant factor in the securities business because of the loopholes opened in the law by bank regulators. There is growing concern in Congress about this, particularly since the Drexel collapse. Just this past week Chairman Gonzalez of the House Banking Committee had a letter delivered to Chairman Greenspan of the Federal Reserve Board urging the Board not to grant any equity powers at this time and to work with Congress in developing a new prudential structure for financial activities, noting that Congressionally-mandated studies of the federal deposit insurance system are underway. It is hoped that banking regulators will heed his urging. With these studies of the federal deposit insurance system likely to be delivered to Congress at the end of this year or early next year, the time appears at hand for Congress to act.

What kind of an arrangement should Congress develop for American financial institutions for the future that will protect depositors, protect investors, protect taxpayers, increase the international competitiveness of American financial institutions, provide for fair competition at home and abroad and preserve at home traditions that Americans have cherished for generations? We think there is a way to do all of these things.

The securities industry is already highly competitive and the increasing presence of banking organizations in our midst may not only endanger the federal deposit insurance system but may also adversely affect individual firms. But the consequences to individual firms are not what cause us concern. The industry does not fear competition. We certainly do fear unfair competition, and banking organizations, with their federal support and credit clout, their too-big-to-fail status, can be unfair competitors in nonbanking businesses such as the securities business. The Comptroller General of the United States agrees. In recent testimony before the House Banking Committee, he stated that there is a "need to be concerned about the extent to which deposit insurance underwrites investments throughout the economy, and there are legitimate questions about competitive equality between insured banks and other noninsured types of financial institutions."

For our industry, these "legitimate questions" are not an intellectual exercise. Unless an effective structure is developed to contain those government-conferred benefits within those parts of commercial banking organizations that conduct traditional banking business, full participation by the banking industry in securities activities could rapidly result in a securities industry that consists solely of organizations controlled by or affiliated with commercial banking organizations. This is exactly what happened in Canada when commercial banks were allowed to engage in the securities business.

The independent securities industry, with its advantages for this nation, its businesses, governments and consumers, could disappear. I do not think it is parochial to suggest that such a development would be a substantial loss to our capital markets and the nation. And it certainly is not parochial to point out that, absent an effective structure for isolating federal support from the securities activities of banking organizations, we would be running the risk of massively increasing the exposure of the federal taxpayer.

It would also be a loss for the United States internationally. As Chairman Breeden of the SEC pointed out in his testimony before the Senate Banking Committee on March 2, 1990, most of the top securities firms in the world are American.

SIA believes that there is an approach which can reconcile the several apparently inconsistent objectives that are being discussed. These objectives include the critical one of reducing the risk to the federal deposit insurance system. They include, whether everyone in our industry thinks it is a good idea or not, restructuring our existing system so that commercial banking organizations may participate more fully in securities activities, both domestically and internationally. And, finally, these objectives should include making it possible for those securities firms that wish to remain independent of affiliations with federally insured commercial banks and to concentrate on what they do best to be able to continue to do so in an environment of fair competition.

SIA is anything but a disinterested bystander with respect to how these important issues will be resolved. For that reason, at its December meeting, the SIA Board of Directors unanimously endorsed a plan which, though still in evolution, could serve to harmonize the somewhat divergent interests of the banking industry, securities industry, depositors, investors, taxpayers and the federal government. A more detailed description of the SIA Plan for Taxpayer Protection and International Competitiveness is attached as Appendix B to this testimony. The basic approach of the proposal is simple.

THE SIA PLAN

A cornerstone of the proposal is the creation of a new entity which can be either a subsidiary of a bank holding company or an affiliate of a securities firm -- an Investment Banking Financing Company (IBFC). The IBFC would not be federally insured, would be authorized to engage in "wholesale" credit and depository activities, and would be permitted to interact fully with subsidiaries engaged in the "wholesale" securities business with no firewalls whatsoever. At the same time the IBFC and its securities subsidiaries would be totally prohibited, with very limited exceptions, from contact with any affiliated federally insured bank. The IBFC, in effect, is intended to become a complete substitute for the support which otherwise might have come from an affiliated federally insured bank which might well be too big to fail -- an unacceptable risk for the taxpayer and an unfair competitive advantage for the commercial banking organization.

Commercial banking organizations desiring to form IBFCs and engage through their subsidiaries in securities and securities-related businesses would be required to conduct all wholesale securities activities within the IBFC/securities subsidiary complex, and would be permitted, but not required, to transfer wholesale credit activities from their federally insured banks to the IBFC in order to benefit from the perceived "synergies" of offering both credit and securities services to institutional customers as if under one roof. If such synergies are deemed critical to serving a particular client, then all credit activities for that client can be carried on in the IBFC.

In effect, a bank holding company's IBFC and its securities subsidiaries would function much like a securities firm that is not affiliated with a bank holding company, with the additional ability to obtain funding through large (perhaps over $100,000 to ensure that the public is not misled) uninsured or privately insured deposits. Because the IBFC complex would not have access to its affiliated federally insured banks, federal deposit insurance would not cause competitive distortion vis-a-vis securities firms.

The IBFC's securities subsidiaries would be required to register as broker-dealers to the same extent that securities firms unaffiliated with banking organizations are required to do so, would be regulated by the SEC to the same extent and would adhere to nonbanking accounting requirements.

To maximize competitive equality, all broker-dealers, whether or not affiliated with a bank holding company, upon meeting certain credit-related criteria determined in advance with the involvement of the SEC, would participate directly in the large dollar payments systems and have emergency access to the Federal Reserve window on a fully collateralized basis in times of generalized liquidity crisis. Any number of plans for participation in the large dollar payments systems would work, including the one suggested by New York Federal Reserve Bank President Corrigan. Perhaps completely private large dollar payments systems could be created.

Emergency access to Federal Reserve liquidity in times of generalized market crisis would not be available to individual firms with liquidity problems absent a generalized liquidity crisis; thus, a Drexel would not have benefitted from such access. Even at such times of general financial crisis, the Federal Reserve would have the last word on the creditworthiness of the collateral offered. Such access is the one sure way in such times of financial crisis as occurred on October 19 and 20, 1987 to avoid having unaffiliated broker-dealers at the mercy of commercial banking organizations which are direct and complete competitors of theirs in the securities business. The Federal Reserve has had the power to extend such liquidity for decades. Therefore, SIA's proposal only involves establishing pre-qualification and access procedures for broker-dealers registered with the SEC. Also, the procedures, once in place, may never have to be used. Their mere existence may eliminate the potential for unfair treatment by commercial banking competitors.

In recent testimony on deposit insurance reform before the House Banking Committee, Chairman Seidman of the FDIC indicated that, with respect to such reform, "the basic idea is to restrict activities that are permitted to be conducted within the bank to those that, in some sense, are judged to pose an acceptable level of risk."

The SIA proposal is posited on the belief that wholesale securities and securities-related activities pose an unacceptable and unnecessary level of risk to federally insured banks, both in light of the degree of risk involved in the specific activities and in light of the fact that such services are being provided capably and efficiently by nonfederally insured organizations.

The well-being and integrity of commercial banking organizations as well as securities firms will be advanced by requiring the conduct of such activities outside their federally insured banks in a way that cannot spill risk back upon such banks. When such separation is required, synergies must be found in another way; the IBFC provides that other way.

The domestic and foreign activities to be transferred from federally insured banks and other affiliates to the securities subsidiaries of their IBFCs include, in addition to underwriting, dealing, placement and advisory services with respect to securities, all such activities with respect to commodities, options, futures and speculative foreign exchange. Conduct of such securities and securities-related activities utilizing a banking organization's own federally insured funds is totally inappropriate because of the levels of volatility and risk and because such activities can be carried on without the support of a federally insured bank.

To take foreign exchange as an example, according to the Bank for International Settlements, average daily foreign exchange trading by banks worldwide in 1989 exceeded a trillion dollars. Banks trading for their own account, as opposed to providing intermediary services for customers, accounted for about 87 percent of their gross foreign exchange volume. Foreign exchange trading by U.S., British and Japanese banks accounted for approximately 60 percent of the volume. Thus, on any given day, U.S. banking organizations expose their own federally insured deposits to huge risks in foreign exchange trading.

A second cornerstone of the SIA proposal is that each federally insured bank in a commercial banking organization which has an IBFC as a subsidiary will be in a "cocoon" as far as contact with the IBFC and its securities subsidiaries is concerned. The objective is this: the federally insured bank will not have any opportunity to assist or participate in commercial, governmental or institutional level securities and securities-related and any other activities of its affiliated IBFC or its securities subsidiaries. The strands of the cocoon would consist of a set of comprehensive, self-executing prohibitions precluding contact between federally insured banks and the IBFC/securities subsidiaries complex. These strands are essential if the objective of permitting banking and securities activities within the same organization while preserving fair competition and safety and soundness is to have any chance of long-term success. The IBFC can be a complete substitute for all affiliated federally insured banks of a bank holding company. In effect, the government is taken out of the competition altogether.

SIA believes it has responded to the call of commercial banking organizations for "synergy." SIA's alternative, the IBFC, solves the problem. At the same time, the existence of the IBFC substituting for all affiliated federally insured banks reduces risks of securities and securities-related activities to the federal deposit insurance funds, depositors and taxpayers.

Regulation can never be perfect, as has been amply demonstrated over and over again. The Comptroller General noted in his testimony about deposit insurance reform that "among the reasons the thrift problem grew to such disastrous proportions is that the regulatory system broke down . . . and federal and state agencies did a poor job supervising the industry." Moreover, according to the Comptroller, even in the thrift area, despite substantial focus on the regulatory problems and the enactment of FIRREA, "we still do not believe that there is complete assurance that the regulatory system will not fail again."

Given the limited resources of our regulatory agencies and the large number of organizations and transactions involved in the banking and securities industries, it is vital that any revised structure include clear prohibitions rather than relying on amorphous concepts such as "arm's length transactions," which cannot possibly be adequately policed by regulators. Prohibition, as a form of regulation, is the simplest, most easily enforced and most effective. In the context of the IBFC structure which SIA proposes, the need for interaction between the wholesale securities operations of a banking organization and its federally insured bank affiliates is eliminated, so the self-operative "no-contact" rules can and will work.

Too much faith cannot be placed in the power of regulators, however competent and diligent. There is always the tendency to believe that the best way for a government to deal with risk in the private sector is to supervise it, to control it. The perfect, all-competent regulator has never lived and undoubtedly never will. The odds favor the effectiveness of the kind of regulation the securities industry has now, where the policeman regulator sets the rules and blows the whistle from the sidelines but otherwise lets market forces operate. Success, failure, mission accomplished or not, no support from or bailout by Uncle Sam.

On the other hand, the highly-regulated and controlled banking sector has had failures resulting in great cost to taxpayers, despite tight-as-possible supervision, specialized bank accounting and other advantages. The absence of market discipline may well have been a factor. Continental Illinois, which cost the insurance funds billions of dollars, was overseen by all federal banking regulators to not much good effect. Could regulators keep up with thrift diversification? By results, no. So there is no reason to believe that increased regulatory supervision and control will be sufficient so that federally insured banks can carry on or directly support the high risk securities and securities-related activities of the banking organization. The SIA believes the safest approach is to cut completely the link between a commercial banking organization's federally insured units and its securities and securities-related activities.

The SIA proposal also has a consumer component. A federally insured bank in a bank holding company would be permitted to operate a "retail" securities brokerage as a direct subsidiary to carry on consumer retail brokerage activities on an agency basis. The federally insured bank would be permitted to fund the activities of that subsidiary. SEC-registered brokers of independent securities firms would be permitted to own federally insured consumer banks to serve consumers at the "retail" level. The consumer bank would be roughly the same as the presently grandfathered nonbank banks (i.e., deposit taking but no commercial loans), except that it would be able to grow within the consumer sphere without restrictions. The consumer bank would be precluded from funding or supporting any activities of its parent or any upstream affiliate and would only service the retail consumer customers of the brokerage business.

Although there may be skeptics among our friends in the banking industry about the SIA plan, it is truly a radical plan. The 1933 Banking Act did two things: it separated banking and securities and created federal deposit insurance. Were it not for federal deposit insurance and the rise of the too-big-to-fail doctrine, SIA's plan would in effect recreate the financial world as it was before Glass-Steagall. However, any plan today must take dangers to the federal deposit insurance system and American taxpayers into account.

SIA has been informed by many that Congress is unlikely to act finally on these issues that are so important for the future of our financial structure and capital markets until after the studies on deposit insurance commissioned under FIRREA are delivered late this year or early next year. SIA will actively participate in the preliminary work that Congress is scheduling this year on these important matters. In addition, SIA hopes to have its detailed proposal ready to present within the next few weeks. SIA intends to work with all parties to develop a new financial structure for the '90s and beyond.

As mentioned, Appendix A to this testimony elaborates on some of the matters contained in the Subcommittee's written questions.

SIA stands ready to assist the Subcommittee in its deliberations in any way it can.

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SECURITIES SUBCOMMITTEE
UNITED STATES SENATE

HEARING ON THE CONDITION OF THE SECURITIES INDUSTRY
March 6, 1990

TESTIMONY OF

ROBERT N. DOWNEY
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

APPENDIX A

SOME SECURITIES INDUSTRY STATISTICS AND OBSERVATIONS

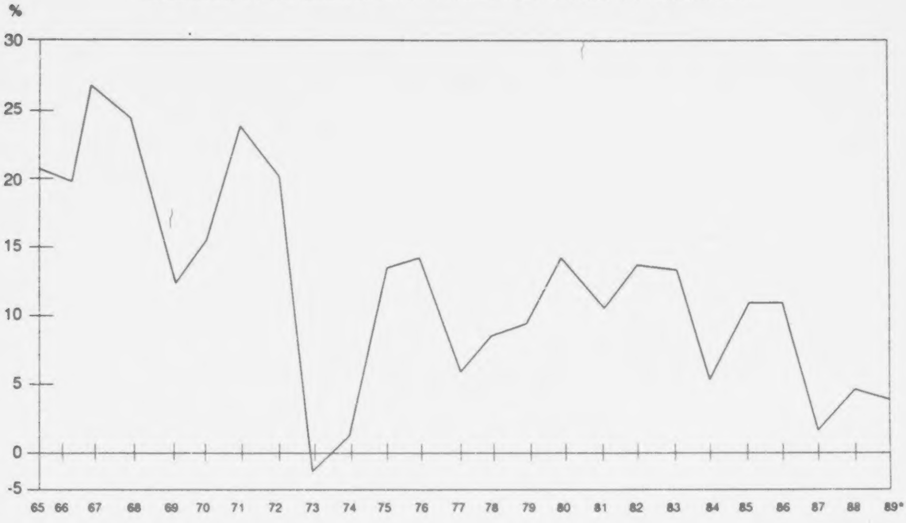
PREPARED BY
SECURITIES INDUSTRY ASSOCIATION
RESEARCH DEPARTMENT

HEALTH OF THE SECURITIES INDUSTRY

One of the best indicators of the securities industry's current state of health can be seen in the graph below. That chart shows the industry's long-term trend in profit margin.

In the 1960s, the industry earned 25 cents on the dollar, on average. Today, it's about a nickel, before taxes.

SECURITIES INDUSTRY PRE-TAX PROFIT MARGIN

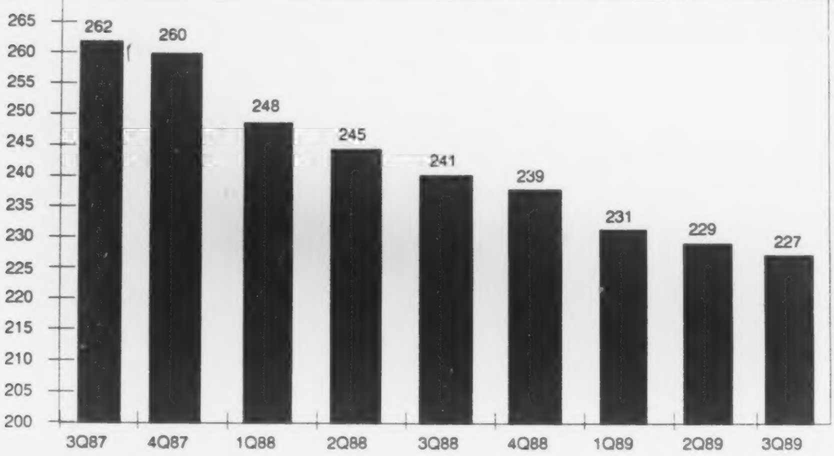


*First Nine Months

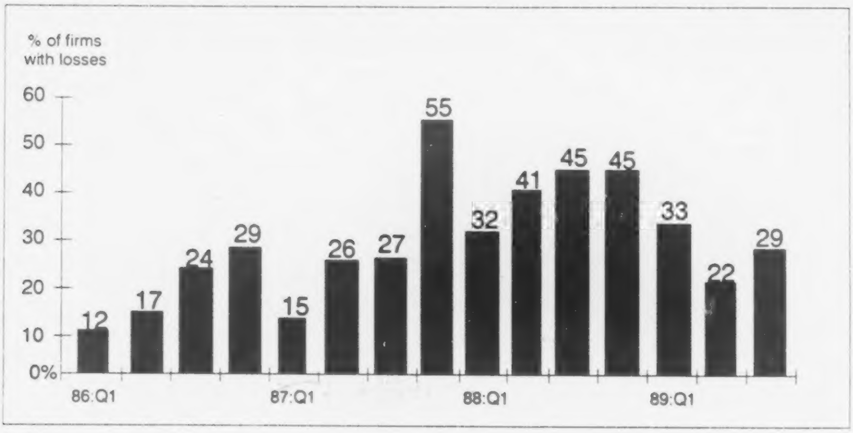
After the 1987 crash, when the industry's health rapidly declined, the industry began to pare back and jobs were the first to go. In the first 24 months after the crash, employment was cut by at least 35,000 (13%). That was through this past September and it is still contracting, probably by another 10,000 including Drexel Burnham Lambert (for a total of 17% through the present). Though these decisions are hard, there is no alternative considering that compensation accounts for three-fifths of the industry's non-interest expenses. There are some other negative charts. The percent of NYSE-member firms which posted red ink when the crash came reached 55% and has been averaging around one-third to one-half since.

SHRINKING EMPLOYMENT SINCE THE CRASH

Securities Industry Employment in Thousands

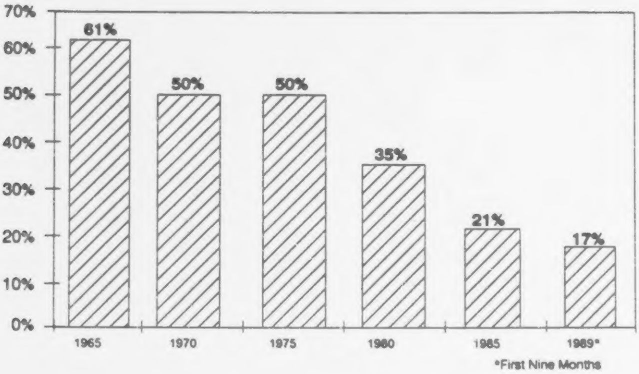


PERCENTAGE OF NYSE MEMBER FIRMS UNPROFITABLE



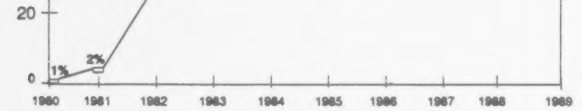
The industry's traditional core business, agency commissions, are now less than 17% of the total revenue stream. In seeking profitability during these highly competitive times, firms have had to act as a principal in taking positions. In the pursuit of any meaningful return, this is the only opportunity of a decent margin and has led to two-thirds of the industry's revenue base now being risk-based (trading, underwriting, investment and merchant banking, etc.).

COMMISSIONS SHARE OF INDUSTRY REVENUES



This same trend has led to an increased concentration of business at the largest firms. The non-syndication of bonds which began with the introduction of Rule 415 in 1982 is almost complete; 87% of the corporate bonds underwritten last year were done without syndication.

NON-SYNDICATED SHARE OF
VALUE OF U.S. DEBT UNDERWRITINGS

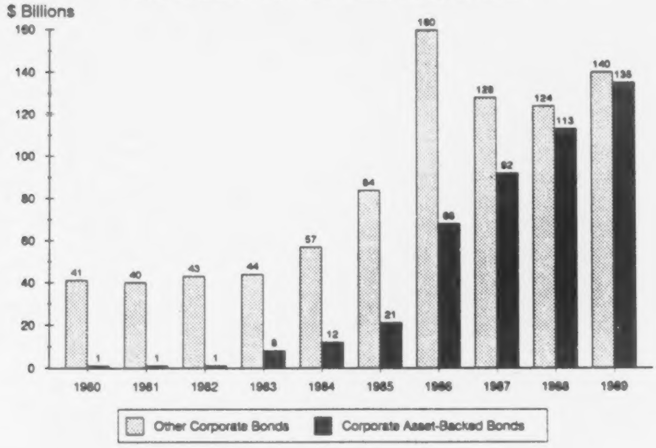


Also, the top 10 firms in terms of capital have 58% of industry revenues and 61% of the industry's capital; the top 25 firms have 78% of revenues and 77% of capital. It is interesting, if not worrisome, to note that among the ranks of these top firms in recent years have been those which no longer exist, at least not as their former selves -- E.F. Hutton, Thomson McKinnon, L.F. Rothschild, A.G. Becker and most recently Drexel. This illustrates how "free to fail" the securities industry really is.

A DECADE OF FINANCING

The 1980s saw a significant increase in the volume of financing brought to the capital markets by the securities industry as well as the introduction of several new financing techniques. Annual debt offerings went from less than $50 billion in the early 1980s to well over $200 billion (1980-89, see chart). Indeed, total debt offerings by corporations reached $274 billion last year, over 5 times the figure for the early 1980s.

U.S UNDERWRITTEN CORPORATE DEBT



Asset-Backed Debt

Much of this increase resulted from the introduction of asset-backed debt, which was almost nonexistent at the start of the decade. By 1989 offerings of asset-backed securities raised $135 billion for issuers, almost equal to the traditional straight and convertible debt offerings. Asset-backed debt allowed issuers to raise funds at a lower cost because it was secured by a particular class of assets, protecting the investor from the risks of deterioration in the issuer's financial position and from "event risk" such as corporate takeovers.

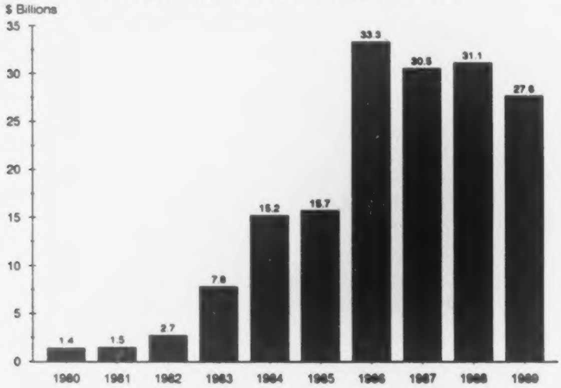
Short-Term Debt

The 1980s also saw a significant increase in the use of short-term debt instruments. Historically high inflation and interest rates in the early 1980s affected the methods by which the capital markets provided financing for the public and private sectors as well as the advice which members of the securities industry rendered their clients on investment. With spiraling inflation and interest rates in high double-digit figures, issuers increasingly sought funds in the short-term markets and raised capital by offering attractive yields on short-term instruments. The yields on short-term debt were so much lower than the yields on long-term debt, it was difficult to recommend long-term financing to those who needed to raise capital. New financing techniques, such as variable interest rate bonds with "puts" and "multi-mode" instruments, were developed to permit state and local government issuers to take advantage of either short-term or long-term interest rates depending on market conditions and other technical factors such as the yield curve.

High Yield Bonds

High yield or "junk" bonds also grew significantly in volume during the 1980s. These securities raised from $1 to $3 billion annually for companies in the early 1980s. By the late 1980s, high-yield bond issues were raising close to $30 billion annually in the public market (see chart). For many companies, including small growth companies, issuing high yield debt was their only way to raise funds in the markets. This was particularly true in light of the modest increases in stock prices until the mid-1980s. In later years, high yield bonds were used more and more to finance mergers and acquisitions, particularly the highly sensitive LBOs. With the recent events in the junk bond market, including defaults by certain issuers of high yield debt and the demise of Drexel, it is difficult to predict what will now happen to the volume of high yield debt. However, the use, terms and conditions of high-yield debt instruments issued in the future are likely to change significantly.

UNDERWRITTEN HIGH YIELD BONDS

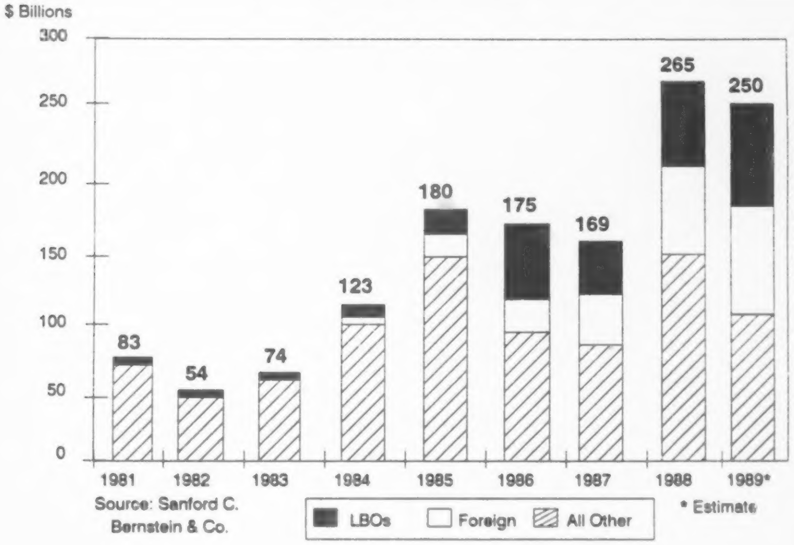


Corporate Restructuring

The past decade saw significant growth in M&A activity and LBOs. M&A activity went from an annual figure of $50 to $80 billion to well over $200 billion by 1988. Last year, completed M&A activity was estimated at about $250 billion, with LBOs accounting for about one-fourth, or $60 billion, of this amount.

Although the securities industry has received some criticism for stirring up such transactions, such activity was primarily market-driven. For many reasons, the stock market and stock prices were not adequately reflecting the value of the underlying assets of corporations. Many companies and individuals perceived that publicly-owned companies would be worth more if they were broken up and the parts sold separately. Thus, a wave of takeovers and threatened takeovers was set in motion by investors and corporations focusing on short-term profit considerations. As a result of this trend, over $500 billion was "retired" from the equity markets in the 1984-89 period.

MERGERS & ACQUISITIONS



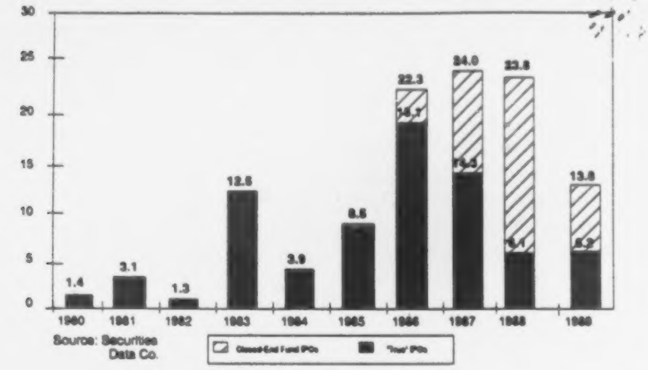
Source: Sanford C. Bernstein & Co.

Equity Capital Raising

The equity markets were not a major source of financing for corporations in the 1980s. If closed-end mutual funds are not considered, raising risk capital for new companies has been virtually non-existent. After peaking at $18 billion in 1986 and then falling to $14 billion in 1987, "true" IPOs raised about $6 billion annually in 1988 and 1989, respectively (see chart on next page). These figures are just slightly higher than the very modest levels for the early 1980s.

"TRUE" IPOs HAVE CRASHED SINCE THE CRASH

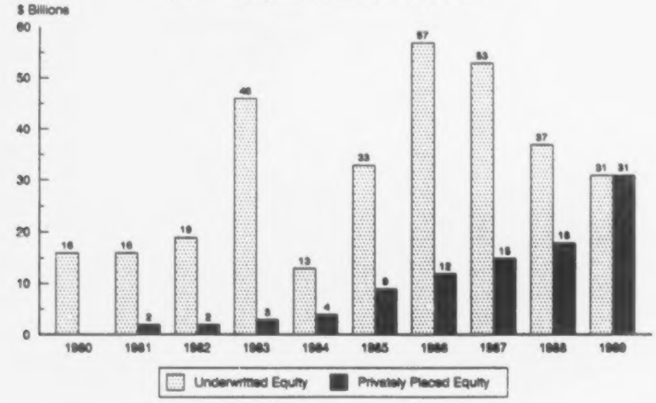
Only Bond Fund IPOs Have Flourished Since the Crash

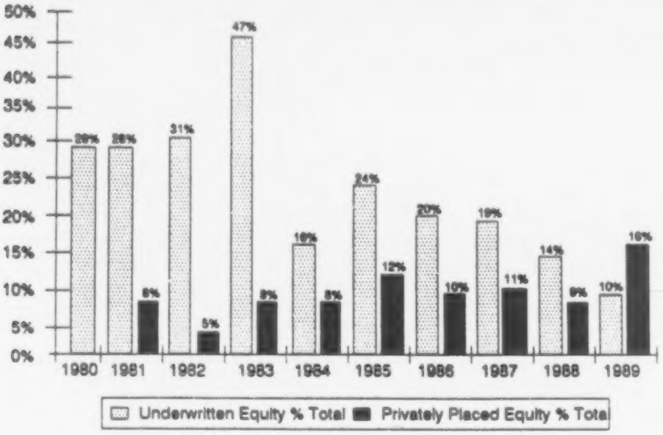


Source: Securities Data Co.

Equity offerings as a percentage of new funds raised domestically are reaching unacceptably low percentages. In the early 1980s, equity accounted for about 30% to 50% of all public new issues (equity was not a factor in the early 1980s' private placement market). The share fell from 47% in 1983 to 16% in 1984 and bounced back to 24% the following year. Thereafter, however, the share continued to dwindle and was down to only 10% last year. In dollars, equity offerings peaked in 1986 with $57 billion publicly underwritten, a figure which also has declined annually to $31 billion last year. At the same time, privately placed equity offerings were few and far between until last year when they doubled to $31 billion, matching the public market's total. Equity offerings as a percentage of the private placement market now exceed the public market's percentage share of equity offerings. The small amounts of new equity issues contrast sharply with approximately $120 billion in equity "removed" from the markets last year through M&A activity and corporate buybacks, which have grown sharply since the October, 1987 crash.

NEW DOMESTIC EQUITY ISSUES





EQUITIES SHARE OF NEW ISSUES

Private Placements

In the course of the past decade, the private placement market has offered a significant alternative to our public markets. Almost $200 billion was raised last year through private placements, up from a level of $16 billion raised in 1980. While this was once a market only for debt, equity offerings now account for 10 to 15% of the capital raised in the private placement market. As noted earlier, the same amount of money was raised through the sale of equities in private placements last year, $31 billion, as in the public market.

While the growth of the private placement market gives certain issuers more options, the lack of use of the public markets is cause for concern. Many issuers and investors do not have access to the private placement market. The nation needs healthier public markets than we currently have in order to meet the anticipated demands for capital in the future.

Municipal Developments

Activity in the municipal area dropped sharply from levels reached in 1985-86 (see chart on Municipal Bond Underwritings on page 10). Much of this trend has to do with the Tax Reform Act of 1986 which curtailed many types of municipal offerings and affected investor demand for tax-exempt instruments. Because of the urgent need of state and local governments to deal with the disrepair of the nation's infrastructure, it is likely that this sector of the capital markets will see renewed activity in the 1990s.

GROWTH IN DEMAND

Corporate Sector

While it is true that domestic M&A activity grew in the 1980s -- from $83 billion worth of completed deals in 1981 to $250 billion last year ($185 billion for U.S.-owned companies) -- this has not impeded the securities industry's traditional capital raising function. Although $60 billion was raised for LBOs in 1989 (up 20-fold from 1981's $3 billion), this amount is still dwarfed by the funds raised through the securities industry's traditional capital raising functions. The following growth figures for the decade of the 1980s underscore the industry's commitment to the nation's capital formation process:

Underwritten corporate bonds	7X	(seven-fold increase)
Corporate medium-term notes	160X	
Underwritten equity	2X	(but 4X back in 1986)
Privately placed corporate bonds	10X	
Privately placed equity	21X	

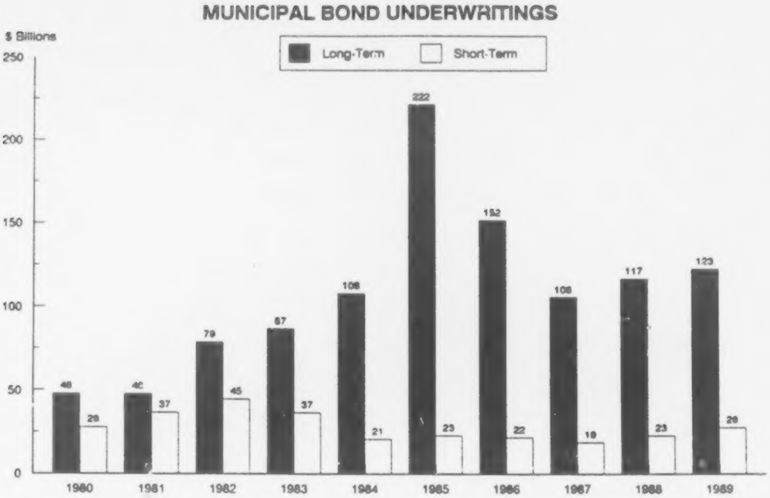
U.S. CORPORATE NEW ISSUES OF THE 1980s

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Underwritten Corporate Bonds	41.6	40.3	43.8	51.9	89.4	104.7	227.7	219.4	236.8	274.1
Medium-Term Notes	0.8	0.8	7.2	6.5	12.3	17.8	37.1	48.6	88.0	127.5
Underwritten Equity	16.0	15.6	19.4	45.5	13.2	33.3	57.1	52.9	37.2	30.6
Privately Placed Corp. Bonds		16.3	25.9	32.7	42.3	70.4	107.1	119.9	172.7	167.7
Privately Placed Equity		1.5	1.5	2.9	3.6	9.3	12.4	14.5	17.9	31.2
Eurobonds by U.S. issuers				0.8	12.0	37.7	41.0	18.8	17.3	15.8

These financings alone totaled $631 billion last year, 10 times the amount of LBOs. Further, while LBO activity is on the wane, these financings will continue to grow this year and into the 1990s. For the decade, $3 trillion was raised in the corporate capital markets (and despite their high profile and extensive coverage, underwritten junk bonds were only 6% of this total through the decade). These financings also are only one part of the securities industry's capital raising efforts. Over $130 billion in Eurobonds were underwritten for U.S. corporations during the past five years in addition to other financings mediated through the securities industry.

Public Sector

Over $1 trillion in new long-term bonds were underwritten for state and local governments during the 1980s, the vast majority by securities firms. Despite the decline in municipal bond financings resulting from tax legislation, last year there were $123 billion in new long-term municipal bonds underwritten (again, the vast majority by the securities industry), the most since tax reform in 1986 and the third highest volume ever.



Beginning in the fall of 1987, and starting with Salomon Brothers, many securities firms began to scale back or exit their municipal underwriting businesses. These cuts were compelled by market conditions. The Tax Reform Act of 1986 caused the amount of business to be cut in half in just two years (see chart) resulting in massive overcapacity in the industry and a corresponding slashing of spreads which led to meager profits and some losses. Although there may be additional downsizing, most securities firms appear to be in the business to stay. It is far too large and important a segment of the capital markets to do otherwise. However, the firms are adjusting their resources to a level consistent with the smaller amount of business being done; they will increase them again when business conditions merit the change, perhaps by the early-to-mid 1990s.

SIGNIFICANT FACTORS SHAPING THE INDUSTRY

Certain of the major factors which are likely to continue to influence events significantly in the securities industry throughout the 1990s, such as globalization and the future mix of the securities industry, have been discussed in some detail in the main part of this testimony. Some additional factors of significance to the future state of our capital markets are discussed below.

Monetary Policy

The 1980s saw a dramatic change in monetary priorities by the Federal Reserve Board that affected the capital markets. The Board no longer utilizes its power to change interest rates as its prime means of affecting economic trends, but instead attempts to control monetary aggregates, or the money supply. One consequence of this change in policy is that interest rates, in general, fluctuate more than was the case in earlier years. This has contributed to greater volatility in the debt markets, with investors wanting to be compensated for the greater risk they perceive. One result has been an increase in "real" interest rates -- nominal interest rates less inflation. As a result, both issuers and investors have concentrated more on short-term instruments. Short-term financing instruments such as commercial paper have increased in volume while long-term straight and convertible debt, after increasing sharply in 1986, has never again reached the 1986 peak of $160 billion.

Fiscal Policy

Fiscal policy also impacts the capital markets. The substantial increase in federal government borrowings has kept interest rates relatively high in recent years. In addition, the Tax Reform Act of 1986 affected our industry and its different products and services. The tax legislation eliminated some tax provisions that were seen as creating tax shelters that were being abused. However, it also eliminated the separate treatment of capital gains for tax purposes which has had an adverse effect upon the equity markets. The tax treatment of equity, with the double taxation of dividends and the lack of any distinction between capital gains and other income sources, is adverse relative to the treatment of debt. In addition, many provisions of the Tax Reform Act have had a negative impact upon securities firms by increasing their tax burdens significantly on international business lines. Changes are needed in these provisions, particularly in the cost of interest allocation between the United States and other nations.

Need for Savings for Investment

An increase in savings and investment is essential for the United States. Our savings rate is the lowest of the major industrialized nations. The resulting lack of funds is clearly hobbling expansion and capital-raising efforts of smaller companies, and thereby costing jobs. Our low savings rate also puts us at a competitive disadvantage since our trading partners with higher savings rates can raise funds more cheaply and compete against us head-to-head in the increasingly global product market.

The securities industry, and in fact the entire financial industry, has long argued there is a need for, and has regularly encouraged, long-term savings and investment which is so critical to the health of the nation. But these efforts have not been and will not be successful as long as our government, at the federal and to some degree the state level, encourages short-term activities and debt relative to equity through the tax regimen and other laws.

A capital gains tax rate reduction is needed to encourage more participation in the marketplace by individuals. Such a reduction will promote the necessary funding for developing and growing companies. Such growth will translate into more jobs for our citizens and economic growth for our communities.

Also needed are targeted tax incentives, including IRAs and similar investment vehicles which have proven themselves as products which encourage the average American to save and invest over the long-term.

Similarly, there is a need to eliminate the double taxation of dividends, which is counter-productive and takes away funds from individuals which might logically be returned to the savings and investment stream.

Need to Rebuild

Another critical issue for the upcoming decade will be the rebuilding of our infrastructure. Across this nation there are outmoded, and in some cases, dangerous roads and rusting and corroding bridges. In virtually every major city there are ruptured watermains and inadequate police, fire and hospital facilities. The classrooms in our nation's public schools still contain inadequate facilities to the detriment of the next generation. Our educational system from books to buildings is not providing the training to enable our children to be prepared for 21st Century competition.

The nation's states, cities and municipalities will have to increase their borrowings substantially in the marketplace to raise the funds to repair these shortcomings. The securities industry will work with government officials to make the repair and replacement of the nation's infrastructure acceptable to the public in a responsible fiscal fashion. A sensible and fair tax policy is needed in order to achieve the needed improvements to the nation's infrastructure.

The Eastern European question is also likely to be a significant factor in the 1990s. From a current perspective -- and at the speed with which events are moving, that view may be eclipsed quickly -- the U.S. securities industry is likely to be a key factor in financing the development of the emerging Eastern European nations. Most of the effort is likely to be via the bond market as governments try to modernize the infrastructure from roads to factories. Similar developments can be expected to occur in Africa and South America as well as other emerging underdeveloped areas of the world.

GLOBAL MARKETS AND 24-HOUR TRADING

To some degree, 24-hour trading exists already, at least in a few major markets, to the extent that one can trade across the world if one chooses to stay up all night and day. Modern communication makes that possible. Real 24-hour trading, however, is not a reality yet because the business and systems are not yet in place. Relatively speaking, very few individuals and relatively few institutions trade around the clock, going from market to market. Moreover, global trading now is limited to a handful of major markets, such as New York, Tokyo and London. That scenario is likely to be New York, Tokyo and an EC marketplace, perhaps London, perhaps not, late into this decade. Further, real 24-hour trading will only come when investors want it. As of now, the average investor in the U.S. does not hold a sizeable amount of foreign securities relative to holdings of U.S. securities. According to SIA's rough estimates, individuals' holdings of foreign equities are about 3% of the value of U.S. stocks.

The total cross-border trading in equities in 1988 was over $1 trillion or 12% of total worldwide securities market trading. Although cross-border trading grew dramatically through most of the 1980s, it has now slowed and is not likely to show the rate of growth seen during the 1980s.

When the demand by investors reaches the point that marketplaces across the world have to remain open in non-traditional hours, that will be real 24-hour trading.

The debt markets are likely to move into automated trading first, because the debt market is primarily a dealer market, which is computer and telephone-based. For example, on a daily average basis, $14.5 billion of corporate bonds are traded over-the-counter. And that excludes the various government securities markets, from municipal bonds to U.S. Treasury securities which also are virtually all over-the-counter.

In addition, at least for most of this decade, the bond market will likely be limited to the same few major markets already cited -- New York, Tokyo and London in the near term, and possibly another EC marketplace after EC92. Germany is a good possibility for that additional or substitute market somewhere after 1992, since it could become the financial link for Western Europe and the United States with a developing Eastern Europe.

Another area for meaningful change in the foreseeable future is the futures and options area, where a much higher degree of automation is necessary.

To achieve these ends, we will need harmonization of the rules across markets here and abroad, in anticipation of real 24-hour trading or even continued growth of international trading. We would like to see harmonization start in the U.S. with one regulator being named for equity and equity-related products -- namely the SEC. Other nations will easily be able to adopt the model. SIA also believes SEC Chairman Breeden's efforts to increase international regulatory cooperation is moving in the right direction.

SEC RULE 144A

The private placement market in the U.S. has been one of the fastest growing capital markets areas in the 1980s and one of the few sectors which continued to grow after the 1987 crash. SEC Rule 144A will encourage much faster growth both domestically (with secondary trading eased and systems like NASD's PORTAL adding liquidity) and internationally. This will now allow the private placement market to be opened up to foreign issuers for the first time to any significant extent. Thus, with onerous reporting and compliance restrictions removed as an impediment to foreign issuers, the U.S. markets will have their own "Euromarket," keeping some U.S. issuers who might have gone overseas at home and encouraging global business to come on-shore.

Much of the impact of 144A on U.S. firms will be to formalize the availability of a safe harbor for secondary trading of private placements, a practice which had been viewed as within the scope of current regulation but not specifically outlined. The SEC states that its mandate is protection of investors but that "sophisticated investors" are well suited to fend for themselves and often command protections far beyond those mandated by regulation. In fact, these investors complain that the regulations adopted to protect investors hurt them rather than protect them. "Internalization" initiatives by the SEC such as Reg S and Rule 144A acknowledge the reality of today's two different investment worlds (institutional and retail) and strike a balance of investor protection while avoiding over-regulation of an institutional market which finds itself often frustrated in the pursuit of investment opportunities by regulations geared for retail investors, regulations which often do not constrain their foreign counterparts.

One important ramification of Rule 144A that has not attained adequate recognition is its implications for unfair competition between banks and independent securities firms.

The concern is that Rule 144A will provide a vehicle for banking organizations to expand the securities activities conducted directly within a bank. Such activity by a federally-supported, federally-insured commercial bank would put registered broker-dealers at a tremendous competitive disadvantage. It is our hope that, before the Rule is promulgated, it will be revised to limit the availability of the Rule 144A safe harbor in the context of banking organizations to Section 20 affiliates of bank holding companies.

In its original proposal, the SEC intended to extend this safe harbor to all classes of securities (and someday may) and to a wide range of institutions which may not be "sophisticated" enough to fend for themselves in today's capital markets. There was concern that extending this safe harbor to equities might cause the development of two equities markets in the U.S. -- one for institutional investors where prices and trading patterns would not necessarily be known and one, the current one, which might become a shadow market for small players only who would be trading without full knowledge of what was happening in the private market. Also, today's institutional investor includes some giants, pension funds with billions under management. However, classifying anyone with $100 million in assets as "sophisticated" might be doing certain investors a disservice, such as a small city manager who knows little about today's complex markets and products and certainly could not demand the disclosure and covenants that a Metropolitan Life could demand of an issuer.

The SEC was made aware of these concerns, and others, and it has modified its proposal to address them. More importantly, it appears the Commission is trying to balance legitimate concerns of today's markets (and international competitiveness) with its original investor protection mandate.

INSIDER TRADING

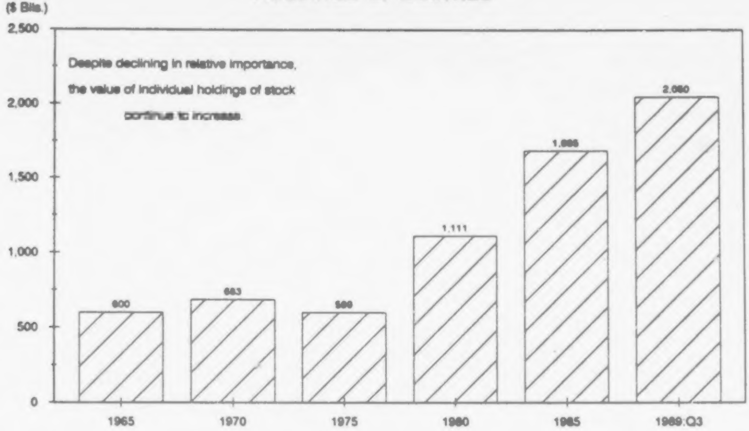
The securities industry needs a definition of "insider trading." Although some legislators and regulators would rather leave the definition vague in order to give the regulators maximum flexibility to cope with changing circumstances in the securities industry, it is neither fair nor reasonable for the industry not to be given clear and cogent rules on conduct to avoid becoming unwittingly involved with criminal allegations. The securities industry feels strongly that those who will abuse the system must be removed from our business and stands ready to work with Congress to ensure a fair and reasonable definition of insider trading.

INSTITUTIONALIZATION AND THE INDIVIDUAL INVESTOR

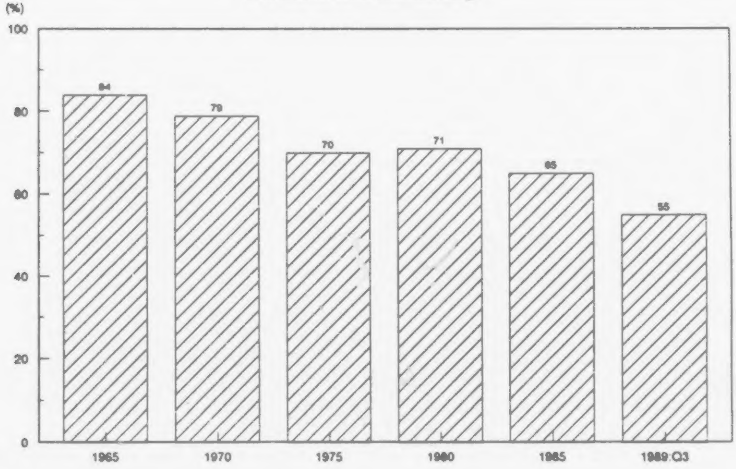
There is no doubt that the market has become increasingly institutionalized. The percentage of stock outstanding held by households has gone from 84% in 1965 to 55% in 1989. Individuals have chosen to participate in the equity markets through mutual funds and pension funds. Nevertheless, individuals still remain the dominant holders of equity even though their proportion of direct stock ownership has declined. SIA estimates that of the $3.8 trillion held in equity during 1989, $2.2 trillion or 58% was held by the household sector either directly (55%) or through mutual funds (3%).

SIA is concerned that increased institutionalization has led to some commoditization of the equity market. Money managers, after reaching a certain size, no longer feel they can beat the averages. Instead, many have adopted passive management strategies and are content to simply keep pace with average performance measures. This, in turn, increases volatility in the market as numerous money managers follow the same policies and respond in a similar manner.

VALUE OF DIRECT INDIVIDUAL HOLDINGS OF EQUITIES



DIRECT INDIVIDUAL HOLDINGS OF EQUITIES
Percent of Total Outstanding



The individual investor has not left the market, but has moved to the sidelines. Again, we should be encouraging, not discouraging, participation by individuals through tax policies that provide incentives to take risks and invest. Treating capital gains as other income, without even an adjustment for inflation, is unfair. The double taxation of dividend income also impairs efforts to attract individuals to the equity market. SIA continues to urge the Congress to pass tax legislation that increases the incentives to save and invest through a more favorable capital gains treatment or through IRA accounts. These tax policies have worked in the past and should work again.

As noted earlier, small business will have a difficult time in raising capital from the public markets. However, institutional investors showed an appetite for NASDAQ stocks in 1989. They bought 1.9 million shares daily, compared to 1 million shares daily in 1988. Their net buying of OTC stocks was the highest for this market since SIA started tracking net purchases during 1986. Again, individuals have been the backbone of small company stocks in the past. Eliminating the capital gains exclusion was not a helpful step in attracting individuals to smaller, riskier stocks. Institutions and the private placement market have stepped into the vacuum and will continue to do so, but they cannot replace the individual investor completely. Unless, we do something positive in this area, we will see the OTC market become institutionalized over time with some very good companies unable to attract investors simply because of their modest size.

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SECURITIES SUBCOMMITTEE
UNITED STATES SENATE

HEARING ON THE CONDITION OF THE SECURITIES INDUSTRY
March 6, 1990

TESTIMONY OF

ROBERT N. DOWNEY
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

APPENDIX B

DESCRIPTION OF SIA PLAN FOR TAXPAYER PROTECTION AND INTERNATIONAL COMPETITIVENESS

DESCRIPTION OF SIA PLAN FOR TAXPAYER PROTECTION AND INTERNATIONAL COMPETITIVENESS

The plan has the following elements:

1. A bank holding company (BHC) having at least one federally-insured bank representing at least 50% of the assets of the BHC would be allowed to form and own an "investment banking financing company" which could take uninsured or privately-insured deposits (possibly restricted to deposits in excess of $100,000 to avoid misleading the public.) The investment banking financing company (IBFC) would be owned directly by a bank holding company; it in turn could own one or more securities subsidiaries to carry on all of the domestic and foreign securities, securities-related and speculative foreign exchange activities of the bank holding company family (in this paper, collectively referred to as "securities activities"). The securities subsidiaries would be registered with and supervised by the SEC and otherwise to the same extent as they would be if not affiliated with a bank holding company. The IBFC would be prohibited from soliciting "retail" deposits and allowed only to take deposits from businesses, governments and institutions. It could not take large "pooled" deposits consisting of smaller accounts, unless the pooled entity has an existence separate from the deposit (e.g., a pension fund).

2. An IBFC's lending business also would be limited to "wholesale" activities, except that it could assist the funding (but not margin loans) of its securities subsidiaries even though they carry on retail brokerage activities. However, commercial, institutional and governmental credit activities would not be limited to those which are involved in securities activities.

3. The IBFC and the securities subsidiaries (collectively called a "securities group") would follow generally accepted accounting principles applicable to nonbanking institutions. Letters of credit and other credit enhancements would also be subject to the same accounting rules applicable to securities and other nonbanking firms.

4. The IBFC could work with its securities subsidiaries as it wished: It could supply credit and credit enhancements to the securities subsidiaries and their transactions; it could participate jointly in transactions with such subsidiaries and jointly market or cross-market with them. Reciprocal inducements for a customer of one to deal with the customer of the other would be permitted.

5. All securities activities (underwriting, dealing, placements, and advising in securities) and securities-related activities (e.g., options, futures and speculative foreign exchange) of a bank holding company family, foreign as well as domestic, would be carried on in an IBFC's domestic and foreign securities

subsidiaries. A limited exception would be provided for consumer brokerage activities on an agency basis for retail customers, which could be conducted in direct subsidiaries of federally-insured banks, but not directly within the bank. The foreign and domestic securities powers of the IBFC's securities subsidiaries would be as determined to be appropriate by Congress.

6. All federally-insured banks in the BHC family and all non-securities affiliates in the BHC family would be completely prohibited from any contact or dealing with any member of the affiliated securities group; however, the IBFC could obtain equity and credit assistance from its bank holding company or any nonbanking affiliate for itself and its securities subsidiaries as long as the BHC and such affiliate had no credit or credit support outstanding to it or for its benefit from any affiliated federally-insured bank or other affiliate that had such credit or credit support outstanding to it. The only exception would be to permit consumer receivables originated by a federally-insured bank within a BHC to be sold "wholesale" through an affiliated registered broker-dealer under reasonable conditions.

7. Federally-insured banks would continue to operate as full function banks as they have in the past, except for the securities activities to be transferred to the securities subsidiaries in the affiliated securities group and the prohibition of any contact with the affiliated securities group or interaction with clients of the affiliated securities group.

8. The IBFC's broker-dealers would be registered with the SEC and the SEC would have the same oversight and control over such securities subsidiaries as it would if they were independent of a BHC, including setting the capital requirements of broker-dealers. The FRB would cooperate with the SEC in ensuring that no member of the BHC family made prohibited credit or credit support available to its affiliated securities group.

9. The affiliated securities group could pay dividends through the IBFC to the BHC and could make credit available to the BHC for its use and the use of other subsidiaries, including federally-insured bank and thrift subsidiaries.

10. The legislation would provide exactly what powers the foreign and domestic securities subsidiaries of a BHC should have consistent with protecting deposit insurance funds and American taxpayers from securities risk.

11. A procedure would be provided whereby a broker-dealer subsidiary of an IBFC would have limited direct access to the Federal Reserve window in times of generalized liquidity crisis on a fully-secured basis. (The Federal Reserve has had the authority for decades to make such liquidity available; therefore, there is no increase in authority involved, only the detailing of a process for such liquidity access in special circumstances.) Such a broker-dealer would also be allowed to be a member of the large dollar payments systems maintained by the FRB and might gain access to the Federal

funds market. The SEC would act with such a broker-dealer in its qualification process with the FRB; no regulatory issues are raised, only the process of qualifying in advance the creditworthiness of the broker-dealer. The FRB would have full discretion to evaluate the worth of any collateral tendered at the time of any liquidity application. The FRB might permit the exercise of such special rights in the IBFC of a BHC itself, should the affiliated securities group request it. In such case, the FRB might determine the qualification for rights itself.

12. The investment banking financing company concept would be made available to the "wholesale" operations of securities and investment banking firms as well. The IBFC affiliated with a registered broker-dealer not in a bank holding company family could raise funds on its own and support its securities affiliates (be they subsidiaries or otherwise). However, such an IBFC would not have any rights to emergency liquidity access at the Federal Reserve, access to the large dollar payments system or the Federal funds market as would the IFBC of a BHC; such rights would lodge only in the SEC-registered broker-dealer. The relationship of the broker-dealer with the FRB would be a "credit" relationship, not an "insurance" relationship.

13. Registered broker-dealers not affiliated with a BHC would be permitted to own and operate federally-insured institutions dedicated to "consumer banking," without limit on their growth and their activities within the consumer sphere. However, in no way could such a consumer banking institution be permitted to fund or support any of the securities activities of affiliated broker-dealers, except that it could assist and cooperate with the consumer retail securities brokerage operations of a broker affiliate in dealing with its customers.

Senator **Dodd**. Thank you very much, Bob, for your testimony.

We've been joined by the chairman of the full committee, Senator Riegle. Mr. Chairman, I welcome you to the subcommittee.

Senator **Riegle**. Thank you, Mr. Chairman.

I just want to say to you and to Senator Heinz how strongly I support the leadership you are giving the issues that you are taking up today and the other pieces of legislation that the Securities Subcommittee is responsible for.

We need to make sure that we get several items enacted this year. I want to say, too, that we've got distinguished witnesses here today and I'm very much interested in what they all have to say and I'm going to ask that the rest of my statement be put in the record.

Senator **Dodd**. Without objection, so ordered.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. I want to commend you, Senator Dodd, for your foresight in scheduling such a topical hearing this morning. I also want to express my strong support for the work you and Senator Heinz have been doing on the Securities Subcommittee. Currently, the subcommittee is working on three important pieces of legislation—the Securities Amendments Act, the Market Reform Act and the Securities Law Enforcement Remedies Act—each in a different stage of consideration. I am committed to working with you in enacting all of these bills this year.

There are two basic issues we should consider this morning. First, we will want to examine the views of our witnesses regarding the basic soundness of the securities industry—especially in light of the high overhead expenses resulting from the expansion of the 1980's and the recent cutbacks. Last Friday, in testimony before the full committee, SEC Chairman Breeden emphasized that "the insolvency of Drexel . . . should not be taken as an indication that U.S. securities markets or other major market participants are financially unsound." We would like to know if today's witnesses agree.

Second, we should consider how effectively the U.S. financial services industry can compete in an era of global markets. For the last several years, we have witnessed the increasing internationalization of the capital markets, which we assume will only accelerate as European integration progresses. To meet the challenges posed by internationalization, Congress must consider whether financial services modernization legislation is required. Equally important, however, is ensuring that our financial services firms are strongly capitalized global competitors.

The 1980's saw changes in the securities industry that were never imagined at the beginning of that decade. While we must prepare for the challenges of the 1990's, we must remain flexible enough to confront the unexpected.

Once again, I want to commend Senators Dodd and Heinz for holding this timely hearing. I also want to compliment them on bringing such a distinguished panel of experts to testify before the subcommittee this morning.

Senator **Dodd**. John, we welcome you here this morning. Welcome to our pit.

STATEMENT OF JOHN H. GUTFREUND, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SALOMON, INC., NEW YORK, NY

Mr. **Gutfreund**. Thank you, Mr. Chairman.

At this time I'd like your permission to submit a full statement for the record.

Senator **Dodd**. Absolutely. Without objection.

Mr. **Gutfreund**. I have worked in the financial industry for 37 years and in that time I have seen many changes because our business by its nature is cyclical. We are at the moment in the midst of a negative cycle. We are also experiencing secular change and I have outlined most of this more completely in my written testimony.

The industry is not without problems. However, overall, in my opinion, we are in sound condition.

Even during the recent Drexel Burnham failure, the markets continued to function and the regulators to do their job.

In my years in this business I've seen the type and level of regulation change dramatically. Most recently, we experimented with deregulation in an effort to ensure that investors and issuers received improved service.

The markets in the United States have not necessarily improved in terms of liquidity and volatility, while markets in some other countries have fared relatively better—ironically, in some cases, with systems modeled on the U.S. prototype.

In some countries there exists very close cooperation between the Government and the financial industry. We in the United States find ourselves in a situation where the Government of the United States in the pursuit of various public policy goals has inadvertently caused the suspension of normal market discipline, thereby incurring for the U.S. taxpayer large economic losses. An example obviously is the thrift industry.

Those of us who were brought up with rules don't always operate best without them. I don't believe that further deregulation will help our markets. Rather, I would suggest that appropriate regulation would balance the public policy goal of taxpayer protection with the need for a globally competitive financial services industry.

I don't come to you with detailed proposals, but in my written testimony I've outlined some options you might consider.

Reform must take place in three areas—regulation, deposit insurance, and safety and soundness. The regulatory apparatus of this country needs to be rationalized along functional lines, encouraging early and active intervention by regulators where problems exist.

With regard to deposit insurance, we need to balance depositor protection with taxpayer protection. The Fed should provide liquidity to protect the system, not to protect shareholders or companies within the system.

We think the Corrigan proposal for changes in the large dollar payment system deserves consideration.

Resolution of these issues will certainly result in structural changes. We hope they will produce a system which provides, first, a level playing field among all parties; and second, a balance between taxpayer protection and the need for our financial sector to compete globally.

Reform of the U.S. financial system is clearly a complex matter. This is true even before we get to the hardest part which is—I don't mean to be rude—the politics. Our challenge here in the United States—and it's a daunting one—is to forge a political consensus among disparate players in a highly fragmented system. And that's a large mouthful. It's in this spirit that I offer my remarks today.

We grew up with the notion that a strong financial sector was a necessity for national and international growth and development and that the United States had the lead role to play in these important matters. At the end of World War II this country promulgated economic policies that helped to create the worldwide economic recovery in which we have all shared.

Dealing with our weakening system is a necessary priority. Whether it's Eastern Europe, Latin America, or the cities of America itself, it is imperative that the United States be politically and economically strong. A strong financial sector is a prerequisite. We have much work to do. Let's get on with it.

Thank you.

[The complete prepared statement of John H. Gutfreund follows:]

TESTIMONY BY
JOHN H. GUTFREUND
BEFORE THE SENATE BANKING COMMITTEE
SUBCOMMITTEE ON SECURITIES
MARCH 6, 1990

Thank you, Mr. Chairman. I am pleased that you are examining the condition of the securities business and the financial services industry. I say the "financial services industry" because this wider definition of the "industry" in question is the appropriate focus for a review of the issues we face.

One goal of my testimony today is to ring an alarm bell about the state of the U.S. financial services industry. Let me convey the rather disturbing picture I see. I will start with the securities sector, which has been going through some rather trying times -- in a very public manner -- as it deals with a series of both secular and cyclical difficulties:

* The overall profitability of the securities business tumbled 15% in 1989 from its 1988 level, which itself was half the level of profitability in 1986.

* Single-digit return on equity is now commonplace among securities firms, while the average return on equity for the S&P 500 last year was close to 17%.

* Overall activity has slowed in many activities which have in the past produced significant profits: e.g., retail brokerage and mergers and acquisitions.

* Commoditization of many products continues, with margins shrinking.

* The sector is still burdened by overcapacity and, as you know, a substantial number of people are losing jobs.

* Most recently, we have had to deal with the dramatic and widely-publicized failure of Drexel Burnham Lambert.

Everyone is aware of the scope and dimensions of the thrift industry problem, so I need not spend a lot of time discussing that. Each day new names are added to the list of thrifts taken over by the RTC. The assets now under the control of the federal government number in the billions; the liabilities are huge. The amount of public funds squandered in this crisis -- a conservative estimate now ranges from $200 to $400 billion -- is a real tragedy. We must prevent something like this from ever happening again.

While all else pales in comparison to the thrift crisis, we should not lose sight of the banking sector, which has its own problems. Brian Pitman, the respected CEO of Lloyds Bank, titled his most recent lecture "Banking in Ferment." And it is.

- Profits are under pressure.

- According to the Federal Reserve, net charge-offs at the top ten U.S. banks over the decade of the '80s have exceeded net income.

- Non-performing loans of the top ten American banks doubled from 1.5% of total assets at the end of 1982 to 3.0% at the end of 1989. And 1982 was the end of a severe recession. The LDC and real estate problems have received widespread attention, and concern is mounting regarding LBO loans.

- In 1980, four of the ten largest U.S. banks had a triple-A rating from both Moody's and S&P. By the end of the decade there were none. Nine large foreign banks do have two triple-A ratings.

- The market valuation of U.S. banks is weak. Price/earnings ratios run between 5 and 7 -- half the P/E ratios of U.S. industrial companies. The ratios for Japanese banks are ten times higher than those of U.S. banks.

- The Japanese market share of all international banking assets has increased from 23% to 40% in just five years.

- Not coincidentally, the ten largest banks in the world, in terms of dollar value of deposits, are now Japanese. Only one American bank ranks among the twenty largest.

- One-quarter of the banking assets booked in the U.S. are now in foreign institutions.

This array of statistics on size, market share, market value, and creditworthiness paints a clear picture of the relative decline of American institutions in the world financial markets. How did our once-dominant institutions reach this state of affairs? Through a combination of macroeconomic and structural forces.

The macroeconomic forces favoring financial institutions of other countries include:

- High domestic savings rates and massive current account surpluses, and

- The strength of foreign currencies versus the U.S. dollar in recent years.

Structurally, our system is fragmented. Two centuries of regulation have created countless obstacles that prevent the industry from functioning efficiently, profitably, and with sufficient diversity of risk. The ability of our institutions to build strong domestic franchises -- a key element in enhancing their ability to compete with foreign firms -- is undercut by a morass of outmoded regulations.

Distrust of concentrated economic power is deeply rooted in the American political tradition. Our system, consequently, reflects greater concern with prohibiting concentration of power and conflicts of interest than with creating a healthy domestic or globally competitive industry.

Further, our political system has viewed financial institutions with suspicion, more as adversaries than as partners. We see no alliance between the U.S. government and the financial industry, as exists in many other countries.

We in the financial sector are concerned about these problems because we recognize:

1. That financial institutions have inherent economic power because of their role in the allocation of financial resources.

and 2. That sound markets and strong financial institutions are cornerstones of economic health and are vital for sustained growth.

Other countries have initiated reforms which have strengthened the efficiency of their financial systems. Japan is currently studying proposals to further enhance the competitiveness of its financial institutions. Action on these reforms is possible next year.

Western Europe is well along in the reform process as part of meeting the 1992 goals for the European Community. Various directives of the EEC contain provisions which establish that

- Universal banks are permissible.

- Supervision is the purview of the home country. Less formality and complexity is assumed than in the current U.S. model.

Unlike the traditional debate in the United States, Europeans are putting substantial emphasis on efficiency, profitability, and global competitiveness. There is less concern with concentration of power. And, in addition, deposit insurance programs are less extensive and mainly private.

Given this state of affairs, it is imperative that we in the United States place appropriate emphasis on the efficiency of our financial system. If we do not, we will jeopardize the ability of the American financial system to compete on a global scale.

What needs to be done? The objectives of reform are straightforward and universal:

1. Strengthen the efficiency of the financial sector through greater competition and more reliance on market forces.
2. Insure the stability and soundness of the system.
3. Adequately protect the average investor.
4. Reduce the taxpayers' risk.

Outlining objectives is easy. The hard part is weighting the importance of each objective. Mixed in correct proportions, these four principal objectives should reinforce each other. Everyone acknowledges that any new arrangements will require adequate supervision in order to function effectively, and will require strong, competitive institutions in order to be stable. The goal should be to balance competition and prudence.

Perhaps the most difficult objectives to balance are taxpayer protection and the need to be efficient and competitive. As I mentioned earlier, we must prevent anything like the thrift crisis from ever happening again. Some feel that separating and limiting activities, is the way to avoid another such crisis. I think going down that road could have very adverse effects on competitiveness.

I thought it might be helpful today to outline a different strategy: Systemic reforms can be instituted that would lower the risk to the taxpayer. Lowered risk would require fewer governmental protections and allow the system to function more efficiently. In order to accomplish these goals, we need to make changes in the regulation and structure of our financial system, and in our basic assumptions about how best to serve the taxpayer.

There are many options for reforming each of these areas. I am not prepared today to tell you exactly which combination of changes I would recommend. I am confident that as the debate continues, the correct pattern will emerge and we can create a mosaic of reform.

But I am sure that we must limit the government's liability -- which is ultimately the taxpayers' liability -- or we will be forced to construct protections that undercut the competitiveness of our financial institutions.

Reform must take place in three different categories -- regulation, deposit insurance, and safety and soundness issues. The theme is the same in each area: limiting the taxpayers' liability. An efficient system of regulation will act as the primary safeguard of this ideal.

Regulation

With regard to the supervisory aspect of regulation, we learned of our weaknesses the hard way in the thrift crisis.

Those weaknesses, simply stated, are that:

* Deposit insurance encourages depositors to be credit insensitive and allows weak depository institutions to fund large, risky ventures. This leaves the taxpayer holding the bag.

* Regulators have been unable or unwilling to constrain tendencies toward excessive risk-taking.

* Regulators are also unable or unwilling to take control of insolvent depository institutions quickly enough to prevent losses.

* When the regulators finally do intervene, all of the creditors of large depository institutions are protected, undermining market sanctions against risk-taking.

We need better defined guidelines for supervisory action, removing insolvent or near-insolvent institutions promptly from the financial system before they inflict losses. We should consider different captial ratio categories calling for progressively stronger supervisory intervention.

With regard to the definitional aspects of supervision, three steps that could improve the system are to

1. Strengthen the risk-based capital adequacy standards developed by the Bank for International Standards (the Basle approach). Work is already under way to learn how best to deal with interest rate, position, and foreign exchange risk.

2. Require the use of market valuation techniques on a regular basis to measure performance against these new capital adequacy standards.

3. Define with more clarity and consistency the term "available capital" (i.e., treatment of loan loss reserves, subordinated debt, etc.).

The operation of our regulatory framework could be enhanced by a system of functional regulation: Same economic function, same regulator, regardless of the institutional form of the entity conducting the activity. Today, different institutions dealing in the same assets can be treated differently or, in fact, not be regulated at all, dependent on the legal structure of the entity.

Functional regulation could certainly lead to an overall reduction in the number of required regulatory agencies, a desirable goal in and of itself. But reducing the number of regulating agencies does not mean deregulation. It means concentrating regulatory power so it can be wielded more effectively.

Deposit Insurance

The thrift crisis has also highlighted the Achilles heel of our financial system -- deposit insurance. What was conceived of as the ultimate protection for the depositor has become the ultimate liability for the taxpayer.

Perhaps we should not be surprised by the difficulties this has caused. In 1933, Franklin Roosevelt said "the minute the government starts [to guarantee bank deposits], the government runs into a probable loss." The extensive U.S. public depository insurance system has the effect of suspending all market judgments about the credit quality of depository institutions.

Various changes have been proposed which would lower the risk to the taxpayer, including:

1. Reducing the level of deposit insurance or limiting it to no more than $100,000 per individual, rather than per account.

2. Having depositors share some of the risk through the use of deductibles or percentage coverage.

3. Developing a program of risk-based deposit insurance premiums: The greater the risk of the asset purchased with federally insured deposits, the greater the insurance premiums.

4. Moving toward a system of private deposit insurance, as is more often the case in Europe.

5. Taking steps to limit the use of insured deposits and thereby lowering the risk (e.g., proposals for a "narrow bank")

Safety and Soundness

Several new approaches to issues of safety and soundness could also lower the risk to the taxpayer.

Putting risk back into the nondepositor creditors' equation is another part of the solution. For the market to work properly, creditors have to believe that failure can actually occur. We have to overcome the concept of "too big to fail."

As Chairman Greenspan said in his testimony before another congressional forum last week, the Federal Reserve plays a critical role in protecting the sound functioning of the financial markets. I would describe this role as one of providing liquidity to allow for the orderly flow of the system rather than insuring that no creditors suffer a loss because of dealings with a financial firm. We have to make it clear -- to ourselves and to the public -- that the Fed exists to protect the system, not the creditors or shareholders of entities within the system.

One key element of the system is the large-dollar payments mechanism. If the functioning of this critical mechanism is improved, the need for intervention by the Fed will decrease.

Gerry Corrigan of the New York Federal Reserve has proposed a reform to the payments system that could prove beneficial. He argues for the creation of a "National Electronic Payments Corporation," jointly owned by the Federal Reserve and the major private sector participants. This new utility-like entity would handle all large dollar electronic payments: tens of thousands of daily transactions with an aggregate value of over $1 trillion. The current payment system is fragmented among the Federal Reserve, the New York Clearing House Association (CHIPS), and other arrangements for futures and options; all payments are provisional, not final; only banks have direct access to the Fedwire and to CHIPS.

Corrigan's proposal seeks to enhance the reliability and safety of large dollar electronic payments by:

1. Having all transactions flow through one system.

2. Making all payments final in the form of debits and credits at the Fed.

3. Giving direct access to certain nonbank financial firms.

We think the Corrigan proposal deserves consideration. And it's also worth exploring whether a totally privatized system is workable.

Structure

A broad systemic reform program encompassing many of the elements just outlined would dramatically lower the risk to taxpayers' dollars that exists in the current arrangement. If we can lower the taxpayers' risk profile, we give ourselves more freedom to design a system that will be more efficient in operation and more globally competitive. We can accomplish the necessary changes without universal banking . . . as long as we first move along the path I outlined previously and protect the taxpayer.

What should our system look like? A few changes are obvious:

A holding company structure with functionally discreet subsidiaries is an obvious choice. The great debate will be about how those subsidiaries relate to each other. One cannot help but wonder how captivated your audience on C-SPAN will be by a debate on firewalls. It may not set any ratings records, but firewalls will be key to the reform program. Much of the debate about them will turn on how much systemic reform there has been and how much the taxpayer risk has been lowered.

At the moment, the Federal Reserve under the Glass-Steagall umbrella has imposed stringent rules on the banks that enter the securities business -- separate subsidiary, separate capital, separate management, separate support, restricted director interactions, to name a few. This set of requirements builds in too much inefficiency. We can do better; we can reach a better balance between competition and prudence. Again, we must design with a global perspective in mind, and we can only do so when we have lowered the risk to the taxpayer.

Price, product, investment, and territorial limits undercut competition and should be eliminated. This means repeal of Glass-Steagall, McFadden, and the Bank Holding Company Act. Their various limits have led to an inability to diversify risks. We've seen the results of that in Texas and New England in a kind of boom-and-bust cycle.

Free flows of capital and investment benefit an economy, and low barriers to entry for foreign firms will enhance competition. While all countries will limit foreign ownership of financial institutions at some point -- this is just a fact of political life in a world of nation-states -- we should prevent any abuse of that limitation and fight to keep the doors as open as possible.

We should be wary of measures designed to prevent concentration of power. Strengthening the ability of domestic firms to compete with each other, as well as allowing foreign firms to participate, should allay our traditional concerns. Where has the financial services industry ever crossed the antitrust line? Or even come close?

Reform of the U.S. financial system is clearly a complex matter. This is true even before we get to the hardest part, which is the politics. Our challenge here in the United States -- and it is a daunting one -- is to forge a political consensus among disparate players in a highly fragmented system. It is in this spirit that I offer my remarks today.

We grew up with the notion that a strong financial sector was a central agent for national and international growth and development, and that the United States had the lead role to play in these important matters. At the end of World War II, this country promulgated economic policies that helped to create the worldwide economic recovery we have all shared in.

Dealing with our weakening system is a necessary priority. Whether it is Eastern Europe, Latin America, or the cities of America itself, it is imperative that the United States be politically and economically strong. A strong financial sector is a prerequisite. We have much work to do. Let's get to it.

Senator DODD. Thank you very much.
Phil Purcell.

STATEMENT OF PHILIP J. PURCELL, CHAIRMAN AND CEO, DEAN WITTER FINANCIAL SERVICES GROUP.

Mr. PURCELL. Mr. Chairman, distinguished members of the subcommittee, I am Phil Purcell, chairman of Dean Witter. We serve over 2 million individual and institutional customers through 7,500 account executives in 467 sales offices.

It's understandable that Congress should be concerned about the state of the U.S. securities industry. Your concern reflects the concerns of millions of individual investors and the concerns of corporate America.

We have just had another big event on Wall Street—the collapse of Drexel—and it's entirely appropriate that the full committee is now holding hearings on what happened.

Clearly, our ranks are thinning. The consolidation on Wall Street is by no means a recent phenomena. If you look back to the top ten retail securities firms in 1980, you will find that five of them—Bache, Shearson, Dean Witter, Smith-Barney and Kidder—are now part of major institutions. Of the five that remained independent, three firms—E. F. Hutton, Thompson-McKinnon and Drexel—are no longer with us.

Despite the turmoil, despite the tough times, I am convinced that our industry is basically sound and that we will weather the present storm to see much better days. It's a cliche to say that Wall Street has its ups and downs, but until October 19, 1987, a lot of people had forgotten about the cycles. You don't have to look back very far to find other tough times. May Day in 1975, the end of fixed commissions which forced a lot of firms under, or the paper crunch in the late 1960's that also caused a large-scale shakeout on Wall Street.

But to us the key underlying trend over the last three decades has been the institutionalization of the markets. Institutionalization simply means the increase in volume and transactions done by money managers, pension funds, and the people who manage or control large pools of assets.

As the institutional business grew, the retail business was becoming less profitable at many firms. Naturally, resources were shifted to serve the growing assets of the institutional customer base, but by the mid-1980's this shift produced an oversupply of services focused on institutional clients which in turn took profitability out of business after business.

Patience is not one of Wall Street's greatest virtues. So when the profits from the traditional institutional businesses began to falter, we saw firms shift to advisory businesses such as M&A. The final step in this process was when firms moved out of the agency business and into a principal role. They did this by placing an unprecedented level of their own capital at risk in businesses like risk arbitrage, bridge loans, LBO, and merchant banking.

We are now experiencing the aftershock of this phase. Firms are reviewing their risk profiles and changing their strategies. It's all part of the natural response to an oversupply of services and the principal orientation. These adjustments, though painful, are basically healthy and normal in the context of past economic cycles in the industry.

Generally, I am not one to advocate legislative or regulatory measures to help moderate the business cycle. Looking to the long term, however, I think there is one area where Congress, with the support of the securities industry, can help.

We've got to find ways to encourage individual investors to be more active participants in the market. Specifically, we need to find ways to restore investor confidence in the market and should take steps to encourage Americans to save and invest more.

Despite the growth of institutional business, it doesn't follow that the individual investor has become extinct. In fact, they are not even an endangered species, at least not yet. They are still in the market in a big way.

Individual investors control the majority of U.S. equities, 57 percent versus the 43 percent held by institutions. It would also be a great mistake to discount the importance of the individual investor to the market. They play an essential role in the capital formation process and in the secondary market pricing mechanism.

From our experience at Dean Witter, most companies have a strong preference for a broad public distribution of their equity securities. Since 1983, Dean Witter has managed or comanaged 126 equity offerings totaling $6.7 billion. Sixty-two percent of that capital came from individual investors. Of the first 5 weeks of 1990, of our new issues, over 80 percent of the capital raised came from the individual investor.

The point is, individuals play a major role in bringing new capital to American industry, a far bigger role than indicated in secondary trading statistics. Companies prefer broad distribution of their stock because it creates a more liquid market and makes their stock less subject to sudden swings. In fact, large numbers of individual investors are the single best cure to our market volatility problems.

While individual investors have a prominent and very important part of the market, it's no secret they have been leery of equities in the past 3 years. The essential problem has been the volatility of the market. The surge of innovation on Wall Street and on South Street has contributed to the loss of investor confidence.

There may be nothing inherently sinister in such things as index arbitrage or triple witching hours, but they haven't exactly been confidence builders.

As you know, the securities industry has already taken steps to address the problem of volatility and we are looking at further steps. We recognize that we are in a business based on trust and we must do everything we can to ensure that the investors have full confidence in the integrity of the markets.

Congress can play a very important constructive role. First, by giving the regulators more up-to-date tools to oversee the markets and second, by encouraging Americans to save and invest more. Let me begin with the new regulatory tools which I think are essential to restoring investor confidence.

First, we recommend that the SEC be given authority over all equity-related derivative products such as stock index futures.

Second, we recommend that a single regulator be given authority to establish minimum margin requirements for all equities and equity-related products. Third, we recommend that investors such as large tax-exempt pension funds be prevented from using their tax-exempt status for excessive short-term profits. Fourth, I think the time has come for Congress to bring the regulatory structure of the financial services industry up to date. The present structure was basically created in the 1930's and it no longer corresponds to the realities of the marketplace in an era of global competition.

Dean Witter has for some time advocated legislation that would help reorder the financial service regulatory environment and bring it into the 20th century. Specifically, we support S. 530, the Depository Institution Affiliation Act, introduced by Senators Cranston, D'Amato, and Garn.

In addition to measures to help restore investor confidence in our markets, we believe individuals need to know that Congress cares about individuals' needs to save and invest. We have been hearing for some time now that our rate of savings is too low, especially when compared to Japan and Germany. I think there is no question that more savings would strengthen our economy by lowering the cost of capital and spurring more investment.

Greater individual savings would also meet a second national objective. American families will be in a stronger position to achieve their own personal goals with financial security, retirement, medical needs, and education for their children.

To help meet these objectives we recommend the following. Expand the tax deductibility of savings through individual retirement accounts, establish a special purpose individual savings account as described in the administration's budget for 1991, and reduce capital gains taxes to encourage long-term investment.

Let me say in conclusion, Mr. Chairman, the securities industry has received its fair share of negative publicity during the last few years. Much of it has been deserved. However, beneath the excesses of the 1980's I believe there remains a broad honest creative securities industry that continues to serve the investment and capital-raising needs of our society.

As the United States embarks on the global economic competition of the 21st century, one of its most effective assets will be a strong securities industry.

Thank you very much.

[The complete prepared statement of Philip J. Purcell follows:]

STATEMENT OF PHILIP J. PURCELL

CHAIRMAN AND CEO

DEAN WITTER FINANCIAL SERVICES GROUP

BEFORE THE SECURITIES SUBCOMMITTEE

OF THE SENATE COMMITTEE

ON

BANKING, HOUSING AND URBAN AFFAIRS

ON

THE CONDITION OF THE SECURITIES INDUSTRY

MARCH 6, 1990

Mr. Chairman and distinguished members of the Subcommittee, I am Philip J. Purcell, Chairman and Chief Executive Officer of Dean Witter Financial Services Group.

Dean Witter is one of the nation's largest broker dealers, servicing a full range of individual and institutional accounts through more than 7,500 Account Executives in 467 sales offices. We engage in the underwriting, marketing, sale and trading of equity products, futures and options and taxable fixed income products.

Mr. Chairman, you have asked us to explore the changes in the securities industry occurring over the past few years and to identify the strengths and weaknesses of the industry today. In addition, you have asked what factors will have a major impact on the industry in the 1990s. To do that, we will address our comments in the context of:

- the state of the securities industry, including environmental trends in the capital markets;
- the role of individual investors; and
- public policy initiatives that can strengthen the economy, the securities industry and, at

the same time, encourage individual investors to participate in the securities market.

I. STATE OF THE SECURITIES INDUSTRY

Because the securities industry is, by its very nature, dynamic, it is difficult to generalize on the condition of the industry. Securities transactions include a broad range of very different businesses within the industry and even within a single firm. For example, some of the classic categories include retail, institutional, investment banking, trading, merchant banking and asset management. Each of these, in turn, have several of their own component businesses.

In assessing the condition of the securities industry, the temptation is to examine its financial performance as the sole indicator of the outlook for the future. While Wall Street today is a strong force in this country's capital-raising mechanism, little is learned from a financial perspective, other than the industry as a whole is producing unsatisfactory returns. To understand the real condition of the industry the fundamental trends in national and international capital needs and firms' responses to them should be examined.

a. Trend Toward Institutionalization

The most significant underlying trend of the 1980s has been the institutionalization of the markets. By institutionalization, we mean the increase in percentage of volume and transactions effected by money managers, pension funds and similarly situated entities managing or controlling large pools of money. This fundamental trend is the root cause of more changes in the industry than any other. And, we believe, it is a long term trend.

Institutionalization had permanently changed the taxable fixed income markets by the 1950s. Since then, it has been an increasing factor in the equity markets. As the customer base shifted, so did the focus of securities firms. Resources shifted and were added to service the growing assets of this institutional customer base.

This shift of resources was also fueled by declining profitability of most participants in the retail business during the '70s and '80s. In fact, the late '80s saw relatively weak retail participation in the equity markets, despite a positive economic environment and increases in most stock prices. That weak participation reflected individual investor reaction to the market breaks of '87 and '89, market volatility, fixed interest rate alternatives, low equity originations and an evolution toward packaged products.

Intensified competition was the outgrowth of the fundamental trends caused by the institutionalization of the markets. The shift of resources eventually produced an over-supply of services. This over-supply, in turn, has severely impacted profit margins in several businesses including:

Corporate Bond Underwriting
Corporate Bond Secondary Trading
Institutional Equity Trading
Municipal Underwriting
Municipal Bond Secondary Trading
Government Bond Trading
Mortgage Backed Trading and Underwriting

During the '80s, firms reacted by shifting focus to advisory fee business such as M&A and to proprietary trading such as risk arbitrage. These trends ultimately led to providing bridge loans and other proprietary merchant banking activities. The LBO-merchant banking phenomenon was a function of high real interest rates, declining nominal rates and the development of the high yield market.

Thus, the response to the eroding margins in servicing institutional customers led to an increase in the risk posture of some securities firms that was without historical precedent. From the perspective of decades, the securities firms changed from being agency brokers servicing a broad range of customers to principal firms often competing with a very narrow range of clients.

The industry is taking several steps to address this current situation. The real risk profile of some firms is now being identified and there will be some casualties in the process. But, we believe, the reaction of many firms will be to reduce their risk profile and to review their strategies. Firms have been forced to reexamine their sources of revenues and associated expenses. This reexamination has included a recognition of increasing competition from commercial banks, affiliates of foreign banks and other global market participants.

Another industry reaction has been to pare back the supply of services offered to clients. Developments over the last two years have reflected this painful but needed reduction in over-supply. The internal adjustments, though painful, are basically healthy and are "normal" within the context of past economic cycles of the industry. The industry is -- and has been -- quite successful at dramatically and quickly changing direction or size to respond to market directions.

b. Retail Trends

The trends in the retail securities business are unique. The longer term trends resulted from the economics of the business. On the one hand, with the deregulation of commission rates in 1975, the institutional markets witnessed the erosion of prices in the form of commission dollars per share and per trade. On the other hand, in 1982 competition for brokers escalated because the number of brokers in retail is key to market share. Both enticement and retention incentives for brokers resulted in higher broker compensation. The primary variable retail cost -- brokers' compensations -- increased from 33% to 43% of revenue produced. Other support and product costs rose as well. By the mid-80s, the retail securities market was one in which margins were razor thin and generally negative. However, since that time, there has been some reversal of that trend and, although profits are thin, they are positive.

Another trend emerged in the '80s that has created a very healthy prospect for retail. This was the combination of retail with asset management. It has reduced some of the cyclical nature of revenues for both brokers and the firms. The combination has really led to a new business. Neither can thrive without the other, but together they can provide an adequate return.

While many had given up on the retail business a couple of years ago, firms are now either shifting their strategy in this direction or are evaluating a retail presence based on poorer prospects of other businesses.

c. Individual Investor Trends

We believe several trends and developments occurring in the securities markets during the 1980s contributed to the changing role of individual investors in the securities markets. Institutionalization of the marketplace, development of futures derived trading strategies and the focus on short term profits have all contributed to the increased market volatility and reduced investor confidence. Despite the dramatic increase in the value of equities in the 1980s, correspondent individual participation in the equities market failed to materialize. This was partially due, we believe, to the market break of 1987 which heightened individual investors' fears of volatility and rapid intra day price movements.

Equity securities, as a percentage of household assets, declined from 25% in 1980 to 20% by mid 1989, all during a period when stock prices were generally increasing.

Notwithstanding their lukewarm reaction, individuals did remain an important factor to the market of the 1980s. While deregulation of interest rates and new packaged products competed with equities, individuals did not completely abandon the equity market. Individuals held and controlled, in mid 1989, the majority of U.S. equities -- 57% -- while 43% were held by institutions. Individuals invested increasingly in equity based mutual funds in the 1980s. Investors currently have $253 billion invested in such funds, according to Investment Company Institute.

The securities industry and the composition and interests of its client base continue to evolve. Evolution poses challenges, but the securities industry is well positioned to fulfill its role in raising capital and delivering investment products to the public. Dean Witter believes that corporate America will go back to basics in the 1990s and tap the equity marketplace. Recent failures and problems will cause corporate America to deleverage its collective balance sheet, and Wall Street will play a vital role as corporations finance, and not merely refinance, their business by accessing the capital markets to strengthen their equity base.

II. THE ROLE OF INDIVIDUAL INVESTORS IN THE SECURITIES MARKETS

We have briefly reviewed the developments of the 1980s and recent trends and will now address what Dean Witter believes are key policy issues for Congress -- the goals of restoring investor confidence and preserving and augmenting the role of individuals in the capital formation process.

Individuals continue to play an important role in the raising of new equity capital and will, in the right environment, play a more important role in the future. Establishing legislative incentives to encourage the flow of new equity capital into the financing of start-up or existing businesses should be a Congressional priority. As is discussed later, the tax code currently provides incentives for highly leveraged restructuring -- but not for the flow of new equity capital into start-up or existing companies. We also believe the proposals -- discussed later -- designed to encourage savings by individuals will improve our savings and investment rate and ultimately lower the cost of capital.

Dean Witter strongly believes that individuals play an essential role in the capital formation process and the pricing mechanisms of our secondary markets. It is our view that most companies have a strong preference for broad public distribution of their equity securities -- either when initially going public or when they return to the market for equity capital. This preference is particularly true with smaller companies for whom raising equity capital may be difficult.

Companies prefer a broad distribution because it results in individuals buying and selling stocks in smaller quantities. Such activities contribute to secondary market liquidity and provide efficiencies in the pricing of equity securities. We believe it is critical in public offerings of smaller companies to achieve a wide distribution where the individual investor actively participates and many of our corporate clients agree. Indeed, many large, well capitalized companies prefer a broad distribution of their equity securities, in which both institutions and individuals participate.

Since 1983, Dean Witter has managed or co-managed 126 offerings in which industrial companies tapped the equity markets. Dean Witter raised a total of $6.7 billion in such offerings, approximately 62% of which came from retail investors. Our recent experience provides further evidence of this point. In the first five weeks of 1990, DWR co-managed five common stock offerings, and participated in numerous others. In the five offerings we co-managed, our customers invested in excess of $156 million in new equity capital. Almost 79% of this new equity capital raised by Dean Witter in those five offerings came from over 7,400 of our individual customers. While the aggregate numbers may appear small when compared to a large program trade, we believe that encouraging individuals to participate in the raising of new equity is what Wall Street should emphasize in the 1990s.

Wall Street also offers investors the combination of an investment in equities with asset management in the form of equity based mutual funds. Investors, as of November 1989, had in excess of $249 billion invested in equity based mutual funds and $50.4 billion of these holdings are in Individual Retirement Accounts. The $50.4 billion accounts for 47% of total IRA assets invested in mutual funds. Individuals clearly believe equities play an important role in their planning for retirement, and we strongly agree.

The individual investor has also been -- and will continue to be -- an important participant in the tax-exempt securities market. Since the Tax Reform Act of 1986, almost 3/4 of all new issues have been sold to individuals, either directly (44%) or indirectly (30%) through sale of tax-exempt mutual funds. The share of outstanding municipal debt held by individuals directly or through mutual funds has increased from 41% in 1983 to 48% in 1986 to 57% in 1989. The rebuilding of America's infra-structure in the 1990s will need even more participation of individual investors.

In addition to capital formation, one of Wall Street's key roles is to provide investors with investment alternatives and opportunities. With the exponential growth of the asset backed securities market, an important, sound investment captured the attention of institutional investors. However, one recent development in which Dean Witter was actively involved is the development of asset backed securities designed for the individual investor. Dean Witter has lead or co-managed four asset backed securities offerings structured for the individual investor in which issuers obtained over $1 billion by securitizing credit card receivables. Over 10,000 of our individual customers invested over $240 million in these offerings. In addition, over 50% of our customers participating in these offerings invested $10,000 or less. These offerings of AAA rated debt securities met the goals of many individuals for quality, long term investments. Indeed, the example provides further evidence that the individual investor can play a key role in the new issue process.

These facts illustrate the importance of the individual investor to the securities markets and the importance of Wall Street to the individual investor.

A challenge for both the industry and Congress is to encourage individual investors to increase their participation in the securities market. To do that, the factors which threaten individual confidence in the securities marketplace and drive investors away must be addressed. Those factors include manufactured volatility, the perception that the equity marketplace is the domain of large institutions and the abandonment of the individual investor by industry participants in the capital markets.

Individuals perceive -- largely because of manufactured volatility due to program trading -- that stock prices no longer reflect the value of the underlying stock. Instead, individuals believe stock prices are a function of perceived pricing inefficiencies in or between the stock and futures market. Those perceptions are in stark contrast with what we believe is a growing public and Congressional conviction that investors should be encouraged to focus on long term, quality investments.

III. PUBLIC POLICY RECOMMENDATIONS

While many of the trends discussed above may continue, Dean Witter has several public policy recommendations directed at what we believe is needed to meet the opportunities and challenges that face the securities industry in the 1990s.

In particular, it is critical that individual investors believe that Congress, regulators and the industry are concerned about them and are trying to protect and preserve their role in the marketplace. While the market has become increasingly institutionalized, Dean Witter believes the individual investor is vital to the marketplace, has consistently maintained a healthy, long term perspective and has a key role in capital formation process in the 1990s. Therefore, we urge Congress to consider public policy initiatives designed to:

- restore individual investor confidence in the securities market;
- encourage individual participation in the markets by enacting proposals designed to increase individual savings and investment; and
- enhance the competitiveness and strength of the U.S. securities industry in an increasingly global marketplace.

a. Investor Confidence

Concentration of assets in the hands of large institutional investors, the presence of derivative products such as stock index futures, the linkage of derivative and cash markets and program trading strategies have contributed to manufactured volatility, which has caused individual and corporate investors to distrust the securities markets.

A broad solution to the issue of market volatility should aim to encourage individual stock ownership which returns public markets to their original purpose: raising capital and providing liquidity for productive enterprises -- rather than reward to those who promote volatility in order to earn short term profits -- so called "one-minute shareholders."

Dean Witter respectfully submits the following as recommendations for solutions to overall volatility:

1. First, we recommend Congress consider proposals designed to link from a regulatory perspective what is an increasingly inter-related, international securities and futures marketplace. Specifically, we recommend the SEC be given authority over all equity related derivative products and one federal regulator be given authority to establish minimum margin requirements for all equity related derivative products.

   We recognize that establishing the SEC as the regulator over all equity related derivative products raises difficult political and business issues. There is a substantial expertise which has developed in the futures marketplace and, in particular, at the Commodities Futures Trading Commission, which any reordering of regulation must strive to maintain and benefit.

   Nevertheless, we believe that a single regulator should have authority over all equity related products, including futures contracts, to enable the regulator to review and address comprehensively the difficult inter-market issues which are ever present and which are exacerbated in periods of market volatility. Because the securities and futures markets are, for securities derivatives, in essence, a single market, uniform regulation under the aegis of the SEC should help to address concerns in the marketplace and is a course of action that we recommend.

For the same reason, we recommend that one federal regulator be granted authority to establish minimum margin requirements on all equities and equity related futures contracts.

2. We recommend that investors enjoying the privilege of tax exempt status, such as pension funds, be prohibited from using their status for excessive short term profits. Public policy initiatives should encourage tax exempt organizations to use long term investment strategies and discourage the use of short term strategies that heighten volatility and destabilize the markets. While tax measures are not the jurisdiction of this Subcommittee, we believe this recommendation, if enacted, would help curb market volatility.

b. Incentives to Save and Invest

In addition to restoring investor confidence in the securities markets, we recommend Congress take steps to specifically encourage individuals to save and invest. We are in a unique position to see how the savings gap weakens our economy. Because Dean Witter places a priority on the long term interests of our individual investors, we are concerned that the lack of savings now endangers their future retirement and other long term financial goals. In addition, low savings rates drive up the cost of capital for U.S. businesses and pose risks to America's global competitive position. Indeed, recent attention on the capital needs of Eastern Europe -- given the political developments there -- graphically demonstrates the importance of considering international capital needs.

Increased personal savings will, therefore, meet three crucial objectives. First, the nation will become more prosperous and competitive. Second, Americans will be in a stronger position to achieve their own personal goals for their financial security, retirement and education of their children. Third, more capital will be controlled by millions of decision makers and not a few institutions.

In light of the importance of increased savings to the nation's economy and to the economic security of individual Americans, we believe that Congress should actively pursue public policy objectives designed to encourage savings and investment. While we recognize that this Subcommittee does not have jurisdiction over tax matters, we believe the following public policy recommendations are relevant and essential to any discussion of the role of the individual in the financial marketplace and the importance of individual savings and investment to capital formation in our country.

Our recommendations would provide incentives for long term savings and investment and would discourage short term, counterproductive strategies. We recommend these changes be made permanent in order to permit consistent long term planning. But, they can be phased in gradually to minimize short term dislocations and any immediate revenue loss.

1. Individual Retirement Accounts - The liberalization of the IRA in 1982 provided the individual with a strong incentive to save. This incentive was largely eliminated in the 1986 Tax Act which curtailed the tax deductibility of IRA investments for most individuals. Dean Witter supports legislation to expand IRAs in order to encourage retirement savings.

Clearly, the greatest incentive to save using an IRA would result if Congress restored the deduction and tax treatment for IRAs to that which existed before the Tax Reform Act of 1986. Recognizing that Congress must also deal with the budget deficit, a more realistic approach at this time would be to modify the tax treatment for IRAs by exempting from taxation withdrawals made at retirement. In addition, we recommend a tax-free withdrawal from the IRA for educational and medical expenses as well as for the first time purchase of a home. We believe this would provide a strong incentive to save by eliminating the double taxation of savings when needed for critical life events and, thereby, improving the after tax return on savings.

2. Establish Special Purpose Individual Savings Accounts - Dean Witter strongly supports the creation of a new "Family Savings Account" as described in the Administration's budget proposal for 1991. The family savings account would make savings more attractive to a larger segment of the population than is reached under current law. Furthermore, the liquidity feature of the family savings account would encourage savings for major expenditures such as housing and education. Any family savings account proposal should permit the

establishment of the account with any financial intermediary without limitation -- this will allow individuals the greatest access to savings products. In addition, the account should allow for a wide range of investments, not only to encourage savings but also to provide competitive rates of return for investors and lower the cost of capital. But, in any event, the investments should be conservative in nature and consistent with the savings objective.

3. Capital Gains Taxes - Congress should reduce capital gains taxes to encourage long term investment. The incentives provided to individuals through lower taxes on capital gains will foster entrepreneurial activity to develop new products and technology, spur growth and provide a higher individual standard of living. By allowing individuals to exclude a percentage of the capital gain realized upon the disposition of a qualified asset -- the amount of which is dependent on the holding period of the asset -- Congress should encourage individuals to invest with a long term perspective. In addition, we believe that venture capital or capital gains from an investment in start-up businesses should receive more favorable treatment than ordinary capital gains. This would stimulate capital development for new business ventures and technologies.

4. Eliminate Double Taxation of Dividends - Double taxation of dividends -- first when earned by the corporation and then again when paid to individual shareholders -- creates a powerful disincentive to invest in corporate America. The tax code currently provides incentives for debt financing. By balancing the playing field and eliminating the double taxation of dividends, Congress would encourage greater equity investment and stronger balance sheets of corporate America.

c. Regulation and Structural Reform

In order to respond to an increasingly global marketplace, we recommend Congress and, specifically, the Senate Banking Committee, turn quickly to the issue of structural reform of the financial service industry. Restoring investor confidence and encouraging savings and investment must be coupled with reform of the regulatory structure for the financial services industry. While the structure has served us well in the 1930s, it is now antiquated and sorely in need of reform if we are to meet the competitive challenges of the 1990s. Congress should consider a regulatory framework that will allow U.S. financial service companies, including securities firms, the ability to offer their customers the range of services that foreign competitors can offer with efficiencies and economies of scale, while at the same time providing appropriate regulatory protections against fraud, unsound or unfair practices, and abuse of Federal safeguards such as deposit insurance.

Specifically, Dean Witter strongly supports S. 530, legislation introduced by Senators Cranston, D'Amato and Garn. This legislation would permit financial and non-financial companies to affiliate with each other, but require the different financial activities to be conducted in a separately capitalized subsidiary of the holding company. These separate activities would be regulated along functional lines by appropriate state and Federal regulators. Reasonable safeguards, or firewalls, would insulate insured entities to protect the insurance funds and assure fair competition and effective regulation.

Similarly, we are supportive of the efforts of the Securities Industry Association to create a regulatory framework to address competitive challenges facing us in the 1990s.

Comprehensive reform of the regulatory structure for U.S. financial institutions would enhance safety and soundness, result in more innovations in meeting consumer demands and strengthen the position of our financial system and the securities industry in the world-wide competition for financial services.

IV. CONCLUSION

The securities industry has received its fair share of negative publicity during the last five years. Some of it was deserved. Unacceptable people and practices have been identified, investigated and prosecuted. However, beneath the excesses of the 1980s there remains the broad, honest, creative securities industry that has served so well the investment and capital raising needs of our society. As the U.S, embarks on the global competitive environment of the 21st century, one of its most effective assets will be a strong securities industry. We urge the Congress to consider carefully our suggestions to strengthen a valuable national asset, its strong capital markets.

Senator DODD. Thank you very much, Mr. Purcell.

Mr. Simons, we welcome you to the committee.

STATEMENT OF W. LUCAS SIMONS, MANAGING PARTNER, J.C. BRADFORD & CO.

Mr. SIMONS. Thank you, Senator.

Good morning, Mr. Chairman and distinguished members of the Senate Committee on Banking. Thank you for giving me the opportunity to speak to you today about the important issues facing our industry and the individual investor.

My name is Luke Simons. I am the managing partner of J.C. Bradford and Company, an employee-owned investment banking partnership. My firm, which was founded in 1927, is based in Nashville, TN. We operate 65 branches in 14 States, primarily in the Southeast region. Two-thirds of my firm's business is retail, which involves working closely with individual investors. We have more than 500 brokers who service the needs of more than 100,000 investors.

I am here today to offer the perspective of a regional investment banking firm on what we consider to be the single most pressing concern facing our Nation's individual investors. That issue is the current volatility of our stock market.

Every day our brokers hear from individual investors who are losing confidence in the stock market. This loss in confidence is driving many individual investors away from investing which threatens the stability of the market and our Nation's economy as a whole, including the capital-raising mechanism.

They are losing confidence, in most part, because of program trading. When we speak of program trading, we speak primarily of the practice of index arbitrage which involves rapid trading of high volumes of stocks and stock index futures to take advantage of price discrepancies.

The concerns voiced to our brokers are not unique to Bradford's clients. In fact, the American Stock Exchange sponsored a survey in August and September 1989 of 500 individual investors and 100 brokers. This survey was conducted just before the most recent October 1989 market shakeup.

The survey showed that 60 percent of the individual investors and 58 percent of the brokers polled feel that program trading is running the stock market. In other words, the tail is wagging the dog.

In response to the growing chorus of concern voiced by individual investors, we at Bradford have been working recently with the heads of other regional investment banking firms to target this issue. Recently we joined with the chief executive officers of 15 regional firms from across the Nation in an informal effort to identify the one change in the brokerage industry that we believe would help restore the confidence of individual investors in the stock market. We basically said, if you had one silver bullet, what would you do?

There were a number of ideas discussed, but in the end our group spoke with a unanimous voice in calling for the establishment of a single regulating body, the Securities and Exchange

Commission, that would regulate both equity and stock index futures with a recommendation that its first order of business be devoted to equalizing margin requirements.

We subscribe to the view that margins should be harmonized across marketplaces to help control speculation and limit financial leverage.

Ironically, though not surprisingly, this unanimous recommendation from the Nation's regional investment banking leaders echoed one of eight recommendations that were presented in the original Brady report which followed Black Monday in October 1987. To date, more than a year after its release, no significant action has been taken on this Brady recommendation.

I am here today on behalf of the regional investment banking community and particularly on behalf of the individual investors we service to ask for your assistance, Mr. Chairman, and the assistance of the other distinguished members of this committee, to help us make this recommendation on program trading a reality. My colleagues and I feel that if this committee moves to make only one legislative proposal on this matter that the proposal be to establish the Securities and Exchange Commission as a single regulatory body of both equity and stock index futures.

This action on the part of this committee and approved by the U.S. Congress, along with the support of our nation's investment banking industry, will go far in restoring the confidence of individual investors in the stock market.

Thank you for giving me this opportunity to speak to you today. I now welcome your questions.

[The complete prepared statement of W. Lucas Simons follows:]

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Testimony by

W. Lucas Simons

Managing Partner

J.C. Bradford & Co.

before the

Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs

March 6, 1990

Good morning Mr. Chairman and Distinguished Members of the Senate Committee on Banking. Thank you for giving me the opportunity to speak to you today about the important issues facing our industry and the individual investors.

My name is Luke Simons. I am the Managing Partner of J.C. Bradford & Co., an employee-owned investment banking partnership. My firm, which was founded in 1927, is based in Nashville, Tennessee. We operate 65 branches in 14 states, primarily in the Southeast region.

Two-thirds of my firm's business is retail, which involves working closely with individual investors. We have more than 500 stockbrokers who service the needs of more than 100,000 investors.

I am here today to offer the perspective of a regional investment banking firm on what we consider to be the single most pressing concern facing our nation's individual investors. That issue is the current volatility of our stock market.

Our brokers every day hear from individual investors who are losing confidence in the stock market. This loss in confidence is driving many individual investors away from investing, which threatens the tradition and stability of the market and our nation's economy as a whole. They are losing confidence in most part because of "program trading."

When we speak of program trading we speak primarily of the practice of "index arbitrage," which involves the rapid trading of high volumes of stocks and stock-index futures to take advantage of price discrepancies.

The concerns voiced to our brokers are not unique to Bradford's clients. In fact, the American Stock Exchange sponsored a survey in August and September of 1989 of 500 individual investors and 100 stockbrokers. This survey was conducted just before the most recent October 1989 market shakeup. The survey showed that 60 percent of the individual investors and 58 percent of the brokers polled feel that program trading is "running" the stock market. In other words the tail is wagging the dog.

In response to the growing chorus of concern voiced by individual investors, we at Bradford have been working recently with the heads of other regional investment banking firms to target this issue.

Recently we joined the Chief Executive Officers of 15 regional firms from across the nation in an effort to identify the one change in the brokerage industry that we believe would help restore the confidence of individual investors in the stock market. There were a number of ideas discussed but in the end our group spoke with unanimous voice in calling for the establishment of a single regulating body, the Securities and Exchange Commission, that would regulate both equity and stock-index futures markets, with a recommendation that its first order of business be devoted to rationalizing margin requirements.

We subscribe to the view that margins should be harmonized across market places to help control speculation and limit financial leverage. We recognize the legal distinctions made by the futures industry that, unlike stock margin, future margin serves merely as a performance bond for assets to which title does not pass. However, we believe that margins must be examined in a broader economic context. Furthermore, margins control leverage to a great extent and therefore, they influence the overall level of risk in the financial system.

Ironically, though not surprisingly, this unanimous recommendation from the nation's regional investment banking leaders echoed one of eight recommendations that were presented in the original Brady report which followed "Black Monday" in October 1987. To date, more than a year after its release, no significant action has been taken on this Brady recommendation.

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This action on the part of this Committee and approved by the U.S. Congress, along with the support of our nation's investment banking industry, will go far in restoring the confidence of individual investors - who are the cornerstones of our nation's economy - in the stock market.

Thank you for giving me this opportunity to speak to you today. I now welcome your questions.

Senator **Dodd**. Thank you very much, Mr. Simons. We appreciate your comments.

Before I get to specific questions, just as a point of information regarding the Brady Commission report and the recommendations in it, we raised this the other day with Chairman Breeden. Senator Heinz and I had sent a letter back in early January asking for specific recommendations from the administration, specifically the Treasury as well as the SEC.

We expect something forthcoming from the administration on the question of margin requirements as well as the single regulatory agency suggestion. But obviously, as you might well imagine, that is not an issue without its political fireworks, and I think the administration wants to sort out its position on that clearly with other agencies before making its formal recommendation. We expect something forthcoming and we have continued to press for an answer to that question.

Mr. **Simons**. I appreciate that, Senator. I think the public is sitting there wondering what's going on.

Senator **Dodd**. Well, we are pressing. Obviously, the answer is important, but if the recommendation is that we ought to take action, then how you do it and the extent you make it possible for us to do it is also important. Having the right answer and an inability to get there is not going to be worth much. So we are proceeding along those lines.

Let me ask a basic question, however you want to respond to this, whether, Bob, you first or John. Al D'Amato and I have a unique interest in the sense that our States, of course more so New York than Connecticut, but still a tremendous amount of interest in what happens with the market because so many of our constituents are participants. That makes us a bit different, but beyond that, there's been a historic justification for our markets and, as you point out, John, this country wouldn't have arrived anywhere near the economic success it's had without a strong securities market. That's axiomatic. It was the ability to raise capital, the ability to build industries and plants, and keep people at work that made our economy flourish.

Second, of course, our markets have been a place to put savings. For the individual investor that you talk about, Phil, this was as good a place to put your hard-earned earnings as any.

But, over the last 8 or 10 years the industry appears to have taken a different course. It's fee driven, transaction oriented, becoming the player rather than the agent.

In effect, to many of us and to the public it seems as if the industry has lost its way. Now you might come back and say:

> Well, look, that may be true. Maybe there were excesses here, but the market has taken care of it. The fact is, Drexel failed. The junk bond market has fallen. Bridge loans are in trouble. The market, in effect, is making the correction here. So, yes, Senator, you're right. Things got off track a little bit, but frankly if you leave it to the marketplace we will resolve these issues.

I assume some of you might answer in that way. Yet, to some of us, we see the aftermath of LBO's, having listened to my colleague, Terry Sanford, on numerous occasions, what happened with leading companies in his State. And it isn't just a question of a loss of jobs. It's charitable contributions. It's support of public institutions.

The impact of these transactions goes far beyond just the loss of companies historic industry in the country.

Respond to that if you will. I hear it all the time. I get it when I go home. I'm sure others do. What's happened to this industry? Is it going to be back on track? Was it just a minor excess that created the problems or in fact are we really not going to see a return of the industry that provided the great engine of capital formation that you rightly pointed out, John, created the kind of wealth that exists in this country?

Mr. GUTFREUND. Well, I really feel very confident. The 1980's were a tough time for me personally because a number of the things in which I believed went down the chute. I think that what happened is that there was a brilliant young man who saw that many American industries were not operating efficiently and thought that that was a great opportunity, and he was right. It was time for those industries to be looked at and looked at hard. The vehicle that was used was financial entrepreneurs.

What happened at the outset was very sound, but as in any situation of that sort, it became by the late 1980's a feeding frenzy and leverage which had been underutilized became overutilized. Margins of safety disappeared and the thing ran its natural course.

At this point two elements are important as far as I'm concerned. I believe—and Phil pointed this out—that we have the possibility here for being the great capital markets of the world still. If you want to raise capital, nothing is better than doing it in America. The markets have always been the deepest, the most liquid, whether you talk Government bonds or the stock markets or the peripherals or the over-the-counter markets. We have a great mechanism here for distribution. The liquidity in these markets is unparalleled and it continues that way even today.

We are not being threatened there, but we have to fortify the markets and some reform is necessary. But I see the 1990's as a chance to again raise considerable amounts of equity. I don't think there's going to be any problem. It will of course go up and down. People have to be happy with lower multiples, perhaps. But there's no question that we are in very strong condition to do that market again.

I think that what happened in the 1980's is like any pattern in the markets. They go too far. I do not see any great concern. Technologically, of course there are fewer companies in the industry. That's an efficiency. The public is better served by these larger, more efficient companies. If people choose to have small companies, that's fine. They have that ability as well. But I think that you have very cheap, attractive service to the individual investor in this country and that will do us very well in the future.

The problem of the 1980's in terms of the excess leveraging, nature has taken care of that. There is no question in my mind that we are still the envy of the world. They copied our rules. They are emulating them. There's no question that we can do very well in the 1990's in our industry with the modifications of the present format.

Senator DODD. I would just make a comment. I would take John's last point to comment that they are copying us and emulating us and they are beating us in some cases. I don't mind being copied or emulated, but I look—and I'm going to raise a point later with a question—John Heinz and I are going to spend all next week in Europe on the whole question of the European market and I read in the Wall Street Journal about the hell you're raising, and rightfully so, about what's being required of U.S. firms to have access to that market.

So I point out to you that——

Mr. GUTFREUND. If it wasn't a tough fight, it wouldn't be worth winning.

Senator DODD. Bob, do you want to comment on this?

Mr. DOWNEY. Well, a couple of aspects. One, of course, is that the individual investor and the investor generally did very well in the decade of the 1980's—the investor in the equity markets. In fact, if one were to invest in equities at this time last year, one would have had much higher return than virtually any other kind of investment.

It's the middle man that got whacked around toward the end of the 1980's. It's the middle man, the investment bankers if you will, who got most severely hurt in the crash of 1987. I think that's the way the system should work.

There were excesses. There's no question about it. There was a lot of wealth created on Wall Street and a lot of that is cyclical and has come the other way, but it will be cyclical again and this industry will continue to be creative and will be creative more in the equity area in the 1990's than in the debt area.

With respect to the international aspect, I think we have to sit back and deal with it not as it's perceived to be, but as it is. As it is, it's the system that America uses—capital system, Glass-Steagall and other things—its the system that Japan uses and 72 percent of the capital market volume in the world is either Japanese or American. Less than 20 percent is the EC 92 countries and the rest of the world is the other 8 percent.

So I think we have to reflect a lot on what's worked very well here and is working well in the rest of the world and there's no question that we are much more open to letting foreigners into our markets than foreigners are—I don't want to use the word reciprocity—to letting us into their markets and that concerns me.

Senator DODD. Phil.

Mr. PURCELL. I would like to just reaffirm a couple of things that Bob and John have stated.

The first is that we not confuse how the customers have done or how the clients have done with the current difficulties in the industry because over the last 7 or 8 years the real returns to all investors in America have been very, very high, whether you were in debt securities or in equity securities. So the customers are doing very well. I think that is the most important point that all of us should remember.

The industry has created some problems for itself because of overcapacity or because of excesses, but the markets are still the best in the world. They are the deepest. They are the most liquid and they are going to remain that way. And the American securities industry is the leader in the world today and there is every reason to think it will be the leader in the 1990's and in the 2000's. So I think we should be very positive on the industry and its future, recognizing that we are going through and we are probably less than halfway through getting the excesses out of the industry and it will affect employment and it will affect pay and it will affect many other things that are important in the State of Connecticut and the State of New York. But when we get through, we will continue to have the best markets in the world and our customers will have assets that they are willing to commit to those securities and the 1990's will be the decade of the equities.

Senator DODD. I presume you would agree that of course that investor did well as long as he didn't invest in broker-dealer stocks. [Laughter.]

Mr. GUTFREUND. Yes, we know that.

Mr. SIMONS. Following up on that, Senator, I think that the investors did do well and I think a lot of the firms that were doing a good job and don't make the news but were trying the heard thing of working with their customers and putting the customers' interest first. I think most of the securities industry, if not all the securities industry, certainly ascribes to that and does a good job of it. Obviously, big failures make big news, but I think underneath that that the securities industry has worked very hard at the difficult part of working with the individual investor and done an outstanding job there.

Senator DODD. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I said in my opening remarks that I was concerned about the confidence of the small investor in the market. All the statistics I've seen shows that the small investor is worried about the market.

One of the issues that seems to bedevil the small investor is the appearance of volatility. Black Monday, October 1987 looked like volatility. October 13 a year ago looked like volatility. Yet, every single study that's been done by the SEC, the CFTC, the New York Stock Exchange or the Brady Commission says that the market is not more volatile today than it was in the past

How do you reconcile these studies with the clear appearance to the investor that the markets are more volatile? Bob Downey, why not kick this to you?

Mr. DOWNEY. Well, we were using the word perception and I think, as I mentioned in my remarks and I think Phil and Luke also alluded to, it's this concern by the individual investor that he can't connect to this system out there, that there are these big gigantic forces moving because somebody pushes a button and you get a wave of selling. I think most studies have shown and I think most of us on this panel would probably agree that the volatility that starts this is usually a natural kind of volatility. But then, when that sets off somebody pushing a button and 200 stocks are sold and bought in the futures and the cash market and that sets off another wave, that's when people are very concerned with it and it's more than perception—it's how do I connect with this madhouse of the computer running the store?

Senator HEINZ. And the position that all of you, I guess, take on functional regulation means inter alia that you would like to have the SEC regulate futures transactions with respect to equities.

Now irrespective of the turf war that that implies, if we could wave a magic wand and bring that about, what do you think the SEC would do that would make a difference when it came to regulating futures?

Mr. SIMONS. I think the key thing from the perception point of view of the individual investor is I think there's a lot of confidence in the Securities and Exchange Commission by the individual investor and I think if the SEC studies it and comes forth and says that this is what we think it should be, I think that would go a long way.

I don't have the answer as to what that should be, Senator.

Senator HEINZ. But my question is more specific. If it's true, as Bob Downey says it is—and it may well be true—that what happens in Chicago after the markets drop in New York sends bigger aftershocks than the first initial shock back through the financial system and the solution to that is to have the SEC regulate both equities and stock index futures, what is the SEC going to do—what would you want the SEC to do that would address that problem?

If the SEC just does what the CFTC does, it doesn't mean anything.

Mr. SIMONS. I think the key thing is we want the control in one place.

Senator HEINZ. That's fine. All you've said is, well, we want people to be on our turf, not on somebody else's turf. That's not what I'm asking.

I'm asking what's going to be different. If you can't come up with an answer, there's no reason for us to shed a lot of blood to get something done if things are going to be the same. We've got other things to do.

Mr. DOWNEY. The SIA's Committee on Market Volatility doesn't just have the recommendation about the SEC as the single regulator. We are developing something which would try to coordinate all the interconnected markets in times of what we call episodic volatility—that's the term we've concluded——

Senator HEINZ. There isn't an increase in volatility, but there is an increase in episodic volatility?

Mr. DOWNEY. Yes. I think that's it. This is a job for the—when natural volatility starts, then this pulsing kind of thing is what's concerning people and how to control that. And to have one regulator be able to coordinate stoppages in the futures market and the cash market and to take a look and to match up orders and that kind of thing is the sort of thing we are working on now.

Senator HEINZ. What I hear you saying is that a single regulator will be in a position to do better damage control, but I don't hear anybody saying that they will be able to administer preventive medicine. I don't know whether that's true or not, but that's what you're saying.

Mr. PURCELL. Senator, I would like to address the question on volatility first. While all the studies would show that volatility day to day or month to month is no different, I believe that the studies that have been done show that intraday volatility is in fact greater and what we hear from our individual clients is that that's what drives them nuts. They want to put an order in and all the sudden the market moves away from them, whether they are buying or selling, for no explainable reason. The investor can deal with things that go wrong with the inflation rate or interest rates, but they can't deal with a mechanical change.

So I think it's wrong to say volatility has not increased. Intraday volatility has increased.

Senator HEINZ. That's why I asked the question. I'm glad you answered that.

Mr. PURCELL. In terms of what could a single regulator do, one of the issues to the individual investor, especially from October 1987, was market access. One of the biggest problems on those days was the system wasn't big enough to handle all the orders and the New York Stock Exchange, with the support of the SEC and the industry, has I think done a remarkable job of increasing the capacity for trades and, more importantly, giving the individual first priority.

That has helped us convince our clients that the market is not rigged against them. It is fair because their orders get there as fast as the biggest institution.

When you come to a single regulator ahead of the problem, ahead of damage control, some of us feel that you can do things in terms of access to the market and they convince the individual clients that they are going to be treated fairly vis-a-vis the institutions and vis-a-vis the locals that a single regulator could help.

Senator HEINZ. Let me ask each of you this. Would you each try and state very briefly whether or not it is your belief that there's a certain kind of index arbitrage that is largely responsible for intraday volatility and think that something, should be done about it? Let me start with John Gutfreund and then just briefly work across the table that way.

Mr. GUTFREUND. I don't think there's anything you can do to eliminate volatility in an age of extraordinary sensitivity in a national technology communications age. I think there is no panacea. I don't think eliminating it would help. It has nothing to do with capital formation as far as I'm concerned. It's a protection for institutional investors. It's a gambling game for the public if they understand it.

I'm not particularly partial to it, but once the car was invented it's going to be hard to do without it.

Senator HEINZ. No speed limits?

Mr GUTFREUND. That's where regulation comes, both quantitative and qualitative. One part of regulation I agree with is a single regulator—I don't care who it is— the quantitative aspect is probably in relationship with margins and making them work systemically.

The problem is the same we have in the industry that you have here in Washington and that is getting people to come together and allowing some of that authority to be pooled in one place. I don't think the problem is that difficult. But I do think the markets have generally served the public extremely well and I don't cry for the people in the industry. They have had some awfully sunny days.

Senator HEINZ. Mr. Purcell, index arbitrage?

Mr. **Purcell**. I agree with everything John said. Index arbitrage is here to stay as long as we have a futures and an options market. I think the issues that have to be addressed in terms of confidence of the clients have to do with the single regulator, more equal margins—not equal margins but some way to maybe slow down the speed with which index arbitrage is dipped into.

Senator **Heinz**. What is that? Sixty volts rather than 110?

Mr. **Purcell**. Well, index arbitrage hits the market very, very fast and moves the market very fast.

Senator **Heinz**. I'm being quite serious. I have no idea how you slow down a computer. They seem to be getting faster, not slower.

Mr. **Purcell**. You slow down the computer by increasing the risk to the person that is pushing the button and there are a set of things that the stock exchange is looking at and others are advocating that I think would slow it down.

Senator **Heinz**. Thank you. Mr. Simons?

Mr. **Simons**. I basically agree with everything they have said. I think it's imperative from the point of view of the individual investor that it come under one regulator because there's so much logic to that.

Senator **Heinz**. But no comment on index arbitrage.

Mr. **Simons**. Index arbitrage, I think it's a market force and it's going to be there.

Senator **Heinz**. Mr. Downey?

Mr. **Downey**. Index arbitrage is here to stay, Senator Heinz. I have been sitting on our program trading and market volatility committee since our first meeting in January. We've probably spent 30 or 40 hours interviewing program traders, interviewing people who would like to shoot program traders, interviewing specialists on the stock exchange, and the one thing——

Senator **Heinz**. What's the ratio?

Mr. **Downey**. Well, we kept it pretty even-steven and I think we've learned a lot from them both. What we haven't learned is, is somebody doing something—I won't say illegal because you cannot "frontrun" yourself and those kind of questions come up—but is somebody really doing something in these episodic volatility periods to juice it up, to cause more volatility and therefore cause the market to be out of whack and have maybe larger spreads. We haven't got an answer yet, but we do know—back to the perception thing—that we think we've got to slow that down and have some harmonization in the futures and the cash markets.

Senator **Heinz**. I have trespassed on the other committee members' time. I thank the chairman for being so generous to permit me to pursue that line of questioning. Thank you.

Senator **Dodd**. Senator Sanford.

Senator **Sanford**. Thank you very much.

Let me pursue a couple of lines of questioning. There are so many lines that we can't get to all of them.

Phil, you pointed out quite accurately that the lack of an adequate savings rate has bothered a great many people and you suggested three ways that it might be increased. All three of them related to the tax policy of the Nation.

One would be the individual types of savings account, then the individual retirement account, and the reduction of the capital gains tax.

The other element that I'd like you to comment on is the public debt, or the lack of savings by the Government. In the next 3½ years we will add another trillion dollars to public debt. Now if we didn't add that trillion dollars, what would that do to the savings rate or what would that do to available capital for other purposes? Is the national debt having an important effect on our savings and cost of capital?

Mr. PURCELL. You're saying that if the Federal Government didn't absorb $3.5 billion of the savings of the country, what would happen to that?

Senator SANFORD. It's now $3 trillion and soon to be $4 trillion.

Mr. PURCELL. I personally would assume that the most likely event is that that capital would be redeployed into hopefully primarily into productive industry in this country. It would be redeployed. Where it would go would depend on market rates and returns.

Senator SANFORD. In spite of our rhetoric here of reducing deficits, there hasn't been any reduction. We haven't reduced a single deficit in the 10 years I've studied it. We have increased it every year. We will increase it about upwards of $300 billion a year by using Social Security and accounting gimmics to mask all the current increases to our national debt.

Is that an impending danger for the securities market or for the Nation or for the economy or does it make any difference?

Mr. PURCELL. I'd like John to comment on his opinion on the markets because there's nobody more expert in the country.

In terms of, is that an economic problem for the country, my training in economics was at the London School of Economics a long time ago, but I think that there is a limit to deficit financing in any country and each country that has passed those limits has paid the price, either in inflation or in devaluation or a serious recession. So I think there's a danger, but I also am a little bit balanced on the question in that our deficit is coming down as a percentage of GNP. You don't agree with that?

Senator SANFORD. While I wish it were the case, it's not factually true. Unfortunately, it's not a question of agreeing. Our deficits are not coming down.

Mr. GUTFREUND. Well, I went to school on the streets of New York in trading, but I think that the perception is the issue there and the perception of the U.S. markets is fine in terms of liquidity.

In terms of safety of principal, we have begun already to pay when you look at our interest rates. You're looking right now at a very interesting phenomenon where you will see pressure on the dollar because the German interest rate has moved so high and the Japanese interest rate is moving high. I think it's because we are totally interrelated now and the temptation in America is always to really emotionally revert to isolationism. We kind of are like an island in our heads, but we're not—in the present world we are not. So the perception problem, which is where I started, I think is going to be very, very difficult for us. I think institutions will move their money around the world. Our currency is and has been de-based by virtue of the increased debt. I think it's just part of a whole myriad of problems that we are presently facing.

We talk about our inability to compete as well as we would like. This is a fundamental core issue. I don't think we can continue to borrow excessively, to use your implied term.

Senator **Sanford**. Maybe you would want to comment on it. Actually, the debt now has exceeded 60 percent of GNP and it's moving rapidly toward 80 percent of GNP These little Gramm-Rudman reductions that we claim are not real. The real deficit is increasing constantly and at an increasing rate because it gets fueled by compound interest. That's just factually true and in another 6 years the debt will be approaching gross national product.

The question is, Is it serious enough for us to stir ourselves about it?

Mr. **Gutfreund**. I would suggest it would be.

Senator **Sanford**. Mr. Downey.

Mr. **Downey**. Yes, Senator, I think it is. Eventually the people who loan us money from Japan and other countries are going to start to, like any debtor who sees the debt getting higher and higher, are going to start putting new covenants into the agreements and is going to be much more demanding. Eventually we're talking about our independence to the extent that we owe everything to somebody else and it's going to be costly to this Nation and we'd better get to it, as John says in his remarks.

Senator **Sanford**. One other line of questions.

John, you indicated that the excesses, certainly the high yield bonds or junk bonds—when they were used as junk bonds rather than high yield bonds—has pretty well run its course. I'm not sure that's quite so and would like your additional comments. It seems to me that SEC sort of lucked out on Ivan Boesky and that brought Drexel Burnham into the picture and that brought Drexel Burnham ultimately down.

But what has happened to stop the urge to put in play a corporation?

Mr. **Gutfreund**. That's a very good question, Senator. I think I understand.

What's happened is the investors are getting a little smarter. It will take a new game to burn them on the next round. There isn't much question. I think it's important not to get carried away with the idea of junk bonds.

Senator **Sanford**. I understand; you made the point and I don't want to confuse the differing uses of these bonds. High yield bonds play a very valuable role and still do with small businesses, but to be used for leveraging 100 percent of a corporation is where they deserve the name junk bonds.

Mr. **Gutfreund**. Yes, but, unfortunately, the popular definition of junk bonds includes everything and it's a huge mistake because emerging companies are terrific companies but they don't have the broadest market access for obvious reasons. So they pay a slightly higher rate of interest on their debt and their stock sells at a slightly lower multiple perhaps in the first instance and as they become proven commodities they get broader and broader markets and better and better trades both in terms of debt and equity. As they deteriorate, then they might be termed junk. But I frankly think it's a market of bonds. It's not——

Senator **Sanford**. I wasn't really questioning the definition of junk bonds or the usefulness of them.

But what is to stop the excessive LBO deal of the 1980's, with its conflicts of interest and the excessive fees paid to the banking industry and securities industry in the deal? What's really to keep us from having another RJR LBO?

Mr. **Gutfreund**. The failure of some of the present ones. That's the only natural market way to deal with those.

What happened was you also had a rising stock market for most of those years. That helped a hell of a lot. What brought it down was that there wasn't a further bit of bid in the game. The absolute level of prices rose so high that to take it restructured and sell it to the next fool—that's a problem. The leverage on the way down—we haven't seen all of that yet. I think that's going to be very important.

Senator **Sanford**. Do you think it's possible for a major company to be leveraged out or to become a "highly leveraged transaction" as the Comptroller General describes it? Do you think an overleveraged buyout is possible today? Could we take over Standard Oil?

Mr. **Gutfreund**. You and me? I doubt it. We are too old. But I would say the possibility is, if a company were sufficiently undervalued, it could be done. But I think it could not be done by an entrepreneur. A group of corporations could do it, as probably they ought to be able to do it. A group of financial entrepreneurs probably couldn't. I think that the investment bankers have gotten their lunch back again. I think the commercial banks, with all their avarice, I think they have been tempered by the present environment and, again, we've only seen the first bit of it.

After all, the liquidation of Drexel which the market handled so well, that was the market part of it. I don't know what the rest of it is.

Senator **Sanford**. Because it's not paper now. It's the collateral for the various corporations that must earn the interest.

Mr. **Gutfreund**. I wouldn't presume to know what that is.

Senator **Sanford**. Well, thank you very much. My time is up. I appreciate all of you being here and your helpful testimony.

Senator **Dodd**. Senator Kassebaum.

Senator **Kassebaum**. Thank you, Mr. Chairman.

First, I would like to say that I think we all agree we need and have had and I think that you feel we have now a strong securities industry and I don't think there should be any question about that.

Mr. Downey, I would like to question a comment that you made. I believe that you said the taxpayers didn't have to pay out anything in this collapse.

That's true. They didn't directly, as they have had to with the S&L situation.

But I think an argument can be made that as a matter of fact the taxpayers will be suffering with the type of short-term mentality that has engulfed the financial markets in the last 8 to 10 years and I think that we have used our capital in a way that I would argue is not terribly productive. It becomes used in putting deals into play and so forth and the excitement of the marketplace rather than the long-term efforts that I think we need to do for research and development and to build better plants, run our businesses in a good old-fashioned way.

I don't think it bears the times and effort to point fingers of blame, but I just do think as a nation we are going to lose if we're not willing to put our capital into investment that is long term, into investment that may not pay out the high dividends in the short term, but that will strengthen us as a nation in order to be competitive with what I think is going to be economic competition instead of a military competition that we have faced.

I would like to ask some questions in that light. One is that Peter Lynch has made the observation that the marketplace is drowning in liquidity at this point at the expense of long-term investment.

Would you all agree with that statement?

Mr. DOWNEY. Well, I think it's very high real short-term interest rates which make it very easy for an investor to not make a bet on a long-term investment when he has a very handsome return on a short-term basis. I don't mean in and out of the market. I mean just investing in Treasury bills, for example. It can be a very prudent thing to do for an investor. It may not be a wise thing long term for the Nation, but for one who's responsible for the investing of funds it could be a wise conclusion.

Senator KASSEBAUM. How do we strengthen long-term investment?

Mr. DOWNEY. Well, several things that we've mentioned would be a higher savings rate certainly and a lower capital gains tax rate, elimination of double taxation of dividends and things of that nature certainly are things that we advance from an economic point of view. That's not the only thing.

Senator KASSEBAUM. So you think a company would make that decision based on those things that you mentioned?

Mr. DOWNEY. Certainly, I think an investor who's subject to tax would definitely make a decision in equities, for instance, if he had a chance to—if he's going to take a chance and make it a capital investment and not get that nice current return from a Treasury bill or something like that, he's going to want to have a better crack if he wins to earn more of that after taxes than the present tax system allows him to.

Senator KASSEBAUM. Mr. Purcell, I think you mentioned pension funds and their role in the markets and I have been concerned about sort of the excess churning of pension funds.

Would you be supportive of a tax on short-term, 6 months and below investments of pension funds in the market?

Mr. PURCELL. I'll answer that question, but first I'd like to come back to the question Mr. Downey answered also.

On pension funds, what I mentioned in my testimony is philosophically in total agreement with your statement in that it seems a pension fund is by definition a very long-term oriented investment and I think that part of the reason for their tax-exempt status is that vision of their role.

So philosophically, I agree that they should be long-term investors as opposed to very short-term oriented with the funds that they invest on behalf of others. And I would do things to encourage them to have that long-term perspective. Whether I would support a tax, I don't know. There are some other ways to address the question. As you know, the mutual fund industry has a short-term penalty. If too much of the earnings of the mutual fund comes from short-term gains, they lose their tax status altogether and the penalty forces them to be longer term in nature. So I don't know that I would endorse the tax per se, but I would certainly endorse looking at the alternatives and forcing them more long term in their outlook.

On your question to Mr. Downey, I think one of the most important things we could do to have a longer term investment perspective in the U.S. is to increase the savings rate which in fact would lower the cost of capital over time to American industry and with a lower cost of capital you are not looking for quite as quick a return and you can be longer term in your planning.

Senator Kassebaum. I couldn't agree with you more on that. I think that is one of the biggest challenges that we have in front of us, and I think part of it is as Senator Sanford spoke of, our own Federal deficit. We have been profligate here as well, but I think that the markets are so influenced by psychology in many ways, it seems to me that when you speak of getting the individual investors back and that confidence, it has to, I think some leadership can come from your side as well as, hopefully, from ours. But we frequently have talked about how we get the deficit under control and have not managed it.

I for one, if there is to be a peace dividend, believe it should go back to erasing the deficit, because that is going to make the biggest difference in the savings from our standpoint here.

I would like to ask again following on questions about index arbitrage, should we outlaw options and futures and say then, I suppose, program trading? That has been suggested by Warren Buffett, I believe, and Peter Lynch and some others.

You all smile, and I——

Mr. Simons. I don't think any of us would be in favor of outlawing any of those instruments.

Senator Kassebaum. Why?

Mr. Simons. Because it's part of the market system. I think they work.

Senator Kassebaum. It didn't use to be

Mr. Simons. Right. But there are a lot of new things that have come out. Some of them work and some of them don't work, and they lead a natural life. I don't think we can regulate them out. I think the market system uses them. I think all we are saying is that we need a single regulator to look at how they are used.

Mr. Gutfreund. I guess I view a lot of these things as a symptom of the hyperactivity and the new technology and the deregulated environment in which we live. I'd like things to be the way they were, and I think that it is very sensible, but the problem is that I don't think that we are prepared to have to forego quarterly reports by corporations. I don't think we are going to look at them on an annual or—I don't think we are in a condition to talk about changing the tax treatment. These problems are all interrelated, in terms of long-term investment, whether it be on the corporate side or on the investor's side. The rewards here are totally in balance at this point toward this kind of hyperactivity as symbolized by these new techniques. And I can understand where Lynch and Buffett come out, but to do that would require a major contra act and it would have to be coordinated.

We have taught the rest of the world about these new fun and gambling games. For us to turn off the tap at this point would be an extremely difficult problem. All we can hope to do, I think, is rationalize it, and that is what the four of us are talking about here, so that we don't unduly penalize those people who have a longer time horizon or those people who work for a living and don't want to gamble every day in the options and stock market.

Senator KASSEBAUM. Well, I'm not advocated it. I was just merely wanting your views, because I happen to respect both of them as investors a great deal, and as fund managers, and was just curious.

Mr. DOWNEY. Senator Kassebaum, just a couple of examples. I have been in the municipal bond business for 28 years, and for a good portion of that time, really until the last 6 or 7 years, there was no futures market, and when you are investing and interest rates are going up, I mean, underwriting, I shouldn't say investing, you need so much more of an underwriting protection, if you can't hedge it on a futures contract. That just makes it much more costly to the issuers, and they paid much higher rates. When futures were invented, the underwriting spreads were reduced, as they should have been and the issuers benefited.

The same thing with Government bonds. I mean, maybe—I don't mean to be facetious, but the deficit of America probably couldn't have been funded except for the futures market and participants being able to lay off risk and hedge risk. Now maybe not having the alternative of futures would have prevented the deficit, but I rather doubt it.

Senator KASSEBAUM. Well, of course, what is very sad is, we have counted on others to help finance our spending here, and the more that happens, and of course, then we deal with a weakened hand in any negotiations, whether it is international trade agreements or any agreements that we wish to make. So I think we all do have a stake in this—the taxpayers, the employees, thousands of them have lost their jobs through all of the shakeouts that have occurred. Change comes. I don't think we can go back.

But on the other hands, we shouldn't be afraid to challenge the way it is working and see exactly what is going to work best for everyone involved.

Thank you. My time is up.

Senator DODD. Thank you very much, Senator Kassebaum. Senator Pressler.

Senator PRESSLER. Thank you very much, Mr. Chairman. I am wondering, and maybe some of you covered this in your opening statements, but it has been well-documented that in a list of the world's 10 largest banks you won't find any U.S. institutions currently, yet American securities firms continue to be among the world's largest, at least as measured by capital and assets, if not profitability.

Do you see our institutions maintaining this position, or will they inevitably fall back as our banks have done, and why are Japanese securities firms so much more profitable?

Mr. DOWNEY. The latter part—Japan has a system very much like America. As you know, Senator, article 65 was patterned after our Glass-Steagall Act, so if there is any example of a country having a system similar to us, it is Japan. They have a very strong banking system, and they have a very strong securities system. The banking system, of course, helped with that wonderful savings rate that they have over there and very low-interest rates until recently, coupled with a very strong yen, again, until recently, relative to the dollar, is what's made those banks so great in assets. As you know, in 1988, American banks had much larger profits than Japanese, but if you go by assets alone, yes, the Japanese are strong and larger for the reasons I have given.

With respect to securities firms, the top four Japanese securities firms are much larger than the American securities firms, and they have the benefit of fixed commissions on stocks, which we haven't, since 1975. But we do have, still as you indicate, a very strong securities industry without any help from fixed commissions or Government help or anything, and it is based really upon creativity. And that is something that we have, as John has indicated, exported. It is one of the strong industries that we have in America, the securities industry, not profitwise, but in creativity and inventiveness.

Mr. GUTFREUND. It isn't that bad on the profit side. [Laughter.] I don't want to cry all the way to the bank here. [Laughter.]

Mr. DOWNEY. Well, I am just using averages for the SIA, John. Some people bring the averages up, I understand. [Laughter.]

Senator PRESSLER. So there is no threat that the same thing is going to happen to our securities industry. The Japanese don't provide that kind of a threat.

Mr. DOWNEY. They haven't done that well over here, Senator, so far. John, maybe you have another view on this. I think it is fair to say that American securities firms have done at least as well in Tokyo as Tokyo firms have done in America.

Senator PRESSLER. OK.

Mr. GUTFREUND. I think that national treatment, with a lot of pressure from a variety of sources, has been effective, and I do think that U.S. firms are in jeopardy. I don't think they necessarily will outrun the Japanese over the long run. The universal banks in Western Europe will be strongly competitive with us, and fundamentally, it relates to this search for profits in the securities and the banks have been in businesses in which they were not formerly engaged, because those businesses through deregulation became profitless, also through—improvement became profitless. And they are not operating, as I said in my testimony, with the kind of arrangement of a national purpose that exists in other countries, where there is a coordination between government policy, the banking system, the savings system.

We have a system that has worked very well here, but it is being tested hard right now and will continue to be, in my judgment.

Mr. PURCELL. Senator, I would point out that most securities markets historically have been dominated by domestic firms, and we have had by far the strongest domestic market, and that is a large part of why we have the biggest and most well-capitalized firms, and as these markets develop in other countries, as they are doing at a very rapid rate, I think we have to expect our firms to be challenged as they have been in banking by others. Hopefully, our industry will respond quicker and will end up not ceding the position that it has today, but I think that that is a battle yet to be fought, because the globalization of securities and the size of the other markets is just beginning to match our own.

Senator PRESSLER. Well, to switch from Japan to Europe and its global securities issues, are you satisfied that given developments in the European Community, a single European market is going to provide legitimate, competitive opportunities for American financial service providers. And do you have any concerns regarding any pending directives or regulations?

Mr. DOWNEY. Well, we are worried about the European system, Senator Pressler, because an awful lot of European banking—they do use the universal banking system in Germany and to some degree Switzerland—and other countries are starting to use it or getting more that way. That seems to be the direction they are going, and we are concerned about that, because they are in many cases so closely related to their Government. I mean, there is no question that a lot of the French banks, for example, Italian banks, are Government-owned, or if they are not Government-owned, they are very strongly Government-supported. And that is tough competition, when you are a private organization, as the securities firms are.

Mr. GUTFREUND. It is a very interesting problem, because it works against us and it works for us, the same way as the banks having a perceived safety net underneath them in America and securities firms not. Over the last 10 years the securities firms probably were a lot more profitable than the major banks were. It works both ways in Europe. And that is what I was alluding to before, the combination of functions where you have the universal bank that not only does the underwriting, makes the market, has the savings. It also controls the equity of many of these companies. That is good for a very long range view, if your strategy is clear, if you have a really brilliant, Teutonic, long-range strategy, right or wrong, it probably will work. The United States has had a totally different model, and our model has worked very well. But it is under considerable pressure and will continue to be. So I would think that we will have to pay attention from the governmental side to the treatment that our securities firms and banks get in the new European arrangements.

Senator PRESSLER. All right. Well, just following up those two international questions, I am concerned about the issue of international securities regulation or the lack thereof. Now in the banking sector, we have seen the establishment of risk-based capital adequacy standards through the Bank for International Settlements. Why haven't we been able to achieve the same level of multilateral cooperation in the securities sector, or should we? Are there steps this Congress or the regulators should be taking to foster a multilateral cooperative environment?

Mr. **Gutfreund**. I think the securities firms are configured very differently than the banks, and a capital adequacy—J.C. Bradford runs one kind of a business and Witter runs another kind of business, and they are involved with a different parentage, and Goldman Sachs is a private partnership, and we are just a poor old public company. [Laughter.]

So each of these is different. [Laughter.]

It is just a modest bit of rhetoric. You fellows are used to that. [Laughter.]

It's not the first time you've heard it.

Senator **Dodd**. No. No.

Mr. **Gutfreund**. I don't think there's a way to go across all boundaries, but I defer to my associates here.

Mr. **Purcell**. I would agree with that.

Mr. **Simons**. I totally agree to that.

Mr. **Downey**. I agree with that, but beyond that there is the question—we have the best disclosure in this world, and a lot of countries and companies in other countries don't like our system, and there is nothing really we can do about that. It would be nice if everybody had the high standards that America does for investors, and that would be something good—if Congress could do something, and maybe in your trips, Senator Dodd, Senator Heinz, you might touch on that, because it works well here, it protects investors. And there is no equivalent, really, in many countries throughout the world.

Senator **Pressler**. One final question, switching back to the domestic. You may have covered this in your opening statements before I was here. But I would like your thoughts on the principal lessons to be derived or to be learned about financial holding companies from Drexel affair, in particular. Some would point to Drexel's collapse as evidence of the need for stringent firewalls to completely cut off the shift of risk exposure to a regulated entity. Others would say the opposite is true, that Drexel demonstrated that better information about the risks within a holding company will allow regulators to protect the regulated entity.

What are your views?

Mr. **Downey**. Again, the system did work here. The customers were protected. However, I think that there will be, by the very nature of the SEC not knowing much about what the holding company had in the way of financials, the thrust is going to go that way and that the holding companies, not necessarily to be regulated but to be reporting their financials is definitely going to happen in some form. How much and how often? Let's say a holding company is involved in a totally unrelated business, but has a subsidiary in the securities business. How much should the SEC know about that holding company's financials, is going to be a very good question. If the holding companies is Sears, they probably don't have to worry. But what if the holding company was Campeau, who might happen to own a securities firm. Those are very big issues.

Mr. **Gutfreund**. This is a very tough question, because if you take a company that is in one business only, and when you begin to examine almost any of the large companies, they are not in one business only. There is no reason that you shouldn't be able to see all the way through, if it is a simple business, but you start talking about companies owned by nonfinancial companies or with nonfinancial parts of their business that are basically financial companies, I think we could spend an awful lot of hours here on that. It is a very tough series of issues.

Mr. **Purcell**. I would like to add a couple points to that. One is that at least as far as anybody can tell and all the forecasts, no customers got hurt in the Drexel liquidation, and that is very positive and is the essence of our capital requirements in the securities business are to protect the customers, and they are working.

In terms of more information from holding companies, there has been a lot of work done on that here in Congress, and I think most of us in the securities industry are working with the risk assessment question and think that there is information from the holding company for an oversight reason that makes sense for the SEC to have, and we work closely with the SEC on the definitions of what kind of information they might need and see no problem, provided it is related to the securities activities and that the information they want should have a material adverse impact on the broker-dealer. And if those two requirements are met, it seems to us that there should be more information available to the SEC on securities activities.

Senator **Pressler**. Good. Mr. Chairman, thank you. If any of the panel members has further thoughts on the European market and things that might need to be done, I would very much appreciate written response. Thank you, Mr. Chairman.

Senator **Dodd**. Thank you. Mr. Purcell, I appreciate your making that last point. Obviously, it is the right to be able to get the information, not necessarily demand the information in every instance, which is an important distinction.

On the European issues, I want to come back in a minute to that, because one of the things we have discovered, Senator Heinz' staff and mine, is just the appalling lack of information within our own government. You know, you read these stories in Monday's Wall Street Journal—"United Kingdom units of your United States securities firms protest European Community proposal on capital levels". As I understand, the companies writing the letters, but why our Treasury isn't screaming, our own Government isn't weighing in on that situation is beyond me.

Certainly, if it were the case here and the U.S. was raising barriers to entry by foreign firms, you would be hearing from the finance ministers of those other countries. You would be hearing from them first. They would be the ones leading the charge on those issues. And here, we act as if it is almost of no interest to us. It is tremendously disturbing. Senator Wirth.

Senator **Wirth**. Thank you very much, Senator Dodd. I appreciate your being here. I always appreciate your counsel.

I know the Brady Commission recommendations have been touched upon briefly earlier today, but I wanted to go back to those, if I might, and get your reaction and your thoughts about where we ought to go from here. You remember that after the market break of October 1987, the Brady Commission came out—this is the commission chaired by the current Secretary of the Treasury, I might add—our current Secretary of the Treasury chaired a commission, and he said at that point that we ought to do at least three things.

One, have one agency coordinating the regulatory issues. One agency coordinating the regulatory issues.

Second, have a clearing systems that are unified.

Third, that margins should be made consistent across marketplaces to help control speculation and to lower the leverage issue.

That was Brady following 1987.

Last week, Mr. Breeden was here, and I asked him a similar kind of question, and he reflected that he thought that if it's a security it's a security it's a security, and that we ought to have a "harmonized" regulatory structure.

Could I ask you what you think at this point ought to be done on this? Mr. Downey, you're the new chairman of SIA; isn't that correct?

Mr. DOWNEY. Yes, Senator Wirth, the securities industry advocates all three of those things advanced in the Brady proposals, and we're on record, and we're strongly in favor of those.

Senator WIRTH. Is there any disagreement on the panel here on the point?

Mr. SIMONS. I don't think there is, Senator. In fact, that was my whole testimony in representing the individual investor.

Senator WIRTH. Why isn't this happening then, do you think? Mr. Downey, why is the administration backing off of this? I asked Mr. Brady about it about 3 months ago, when he was here, and he didn't want to talk about it. Why is that?

Mr. DOWNEY. I don't think it is something that we in the industry can answer as well as perhaps the Senate and the House. At least from our perspective—on the outside looking in kind of issue, it seems as though it is a jurisdictional thing, as much a problem in your industry, government, as it is in ours, which is the securities side.

Senator WIRTH. But it ought to be done, you're saying.

Mr. DOWNEY. By all means, it ought to be done.

Senator WIRTH. In the safety and soundness of the consumer——

Mr. DOWNEY. Absolutely. Senator, we are beating the drums for it. We strongly are, and we think that—I mean we were told that the chances of this occurring were very slim a year or so ago. Now they seem to be a lot stronger for something like this to happen. We are very strongly supportive of that, the whole industry.

Mr. SIMONS. Senator, the individual investor has seen since October 1987 nothing happening, nothing. And it is a great frustration.

Senator DODD. Nothing at the governmental level. You have had a number of things happen at the market level. [Laughter.]

Mr. SIMONS. But not perceived by the individual investor.

Senator DODD. Well, I don't know. There may be other reasons. My view would be the exchanges have done——

Mr. SIMONS. The exchanges have done a lot.

Senator DODD. A tremendous amount.

Senator WIRTH. Are the margin requirements the same now? They aren't, are they?

Mr. SIMONS. No, they aren't.

Senator DODD. They are not——

Mr. SIMONS. No.

Senator WIRTH. The margin requirements aren't the same, are they?

Mr. SIMONS. No.

Senator WIRTH. Isn't there an enormous amount of leverage left in the Chicago markets compared to what is here and a lot of potential for—I thought coming with that one of the lessons of 1987 was that there was a great deal of volatility that came along with that leverage and a very, very small margin requirement. I thought that we learned that as well, presumably, in the S&L business, you know, and if we have learned anything from history, we have learned that what we ought to be moving into is to require the same—I would think, the same kind of margin requirements out of one exchange as in another. I mean, is there any reason not to do that? And that has not, has it?

Mr. SIMONS. No.

Senator WIRTH. Is that the single most important thing to do?

Mr. SIMONS. Well, I think we feel like having a single regulator first and then assigning the task to the single regulator of examining the margin requirements.

Senator WIRTH. Then the whole question of clearance was another problem, isn't that right, that was of great concern in the Brady Commission. That has not been done, has it?

Mr. SIMONS. I think some things have been done there. In fact, there have been probably more done in that area than any other area.

Mr. Purcell. Major steps have been made in the clearance and settlement. Major steps there.

Mr. SIMONS. Yes.

Senator WIRTH. Let me, if I might, jump to the issue of holding companies in all of the news we hear from Drexel and the alleged upstreaming of money from the regulated Drexel to the parent holding company that is unregulated, and it is pretty clear that that transpired, that the SEC said, Mr. Breeden, as of last week, did not know what was going on. As you were saying, Mr. Downey, just a little while ago, we did not have information on that, and I guess everybody is in agreement that we ought to develop some kind of a structure that allows us to have information on what a parent company is doing.

Is that right?

Mr. DOWNEY. Yes.

Senator WIRTH. Is everybody in agreement on that?

Mr. DOWNEY. Yes.

Mr. GUTFREUND. Phil mentioned that Sears being an industrial company, owning Dean Witter, was prepared to have information of a necessary sort provided by them for Dean Witter to operate in the securities business. I think that that happens to be a very enlightened management. Probably it ought to be to some extent mandatory. But that is your business, not ours. I think, yes, would that be public protection? Certainly, it would be.

Senator WIRTH. Have you seen the proposal that Mr. Corrigan has made on this front, that he talked about minimal capital standards and a limited degree of consolidated supervision and how that goes to parent holding companies? Have you seen that proposal by Mr. Corrigan?

Mr. Downey. Yes. I have seen reports of his proposal.

Senator Wirth. And do you agree with that? Is that also consistent with the SIA's position?

Mr. Downey. No. I think we would like the information to go to the SEC, not necessarily to the Fed. Maybe we are not reading it correctly, but there is a potential for excess regulation—until we get some real benefits, you know, from the Fed, or access to the window or things of that nature, it would seem—we would just as soon report to the SEC as opposed to the Fed on these issues, if that is what he has in mind as a consolidated overseeing regulator. We are a little unclear as to who he has in mind there.

Mr. Purcell. Senator, it seems from what we have read that there is an essential difference between Mr. Breeden's position and Mr. Corrigan's, in that what the SEC is proposing is a way to have oversight as opposed to what it appears to me that Mr. Corrigan is proposing, which is new regulation of holding companies, and I wouldn't want to be misunderstood to endorse the Corrigan approach, because I do not think that is necessary at all, and the step we should take is something more along the lines of Breeden and have oversight for any activities related to securities, where it may have a material adverse impact on the broker-dealer. And that makes sense, and I think the industry can support it.

Speaking for myself, I would not vote in favor of a new form of regulation at the holding company level either by the Federal Reserve or by the SEC.

Senator Dodd. In fairness to Chairman Breeden, he did say that. He also said he would withhold judgment on the minimum capital standards until he saw how things worked for a while. He may come to that point eventually.

Mr. Purcell. Yes. And I would agree with that too.

Senator Wirth. And as you said, it is a very complicated issue, Mr. Gutfreund, you pointed out it is, but it clearly seemed to suggest coming from all quarters that a rethinking of the supervisory structure would seem to be in order and that is something that we ought to be doing.

Mr. Chairman, I thank you very much. I have raised these issues of our regulatory responsibility. I think that there was a pretty proud history on the Hill of maintaining strong regulation at the SEC. During the early 1980's when there was this mad rush to deregulate, sort of a rush to the bottom, a rush to the lowest common denominator, there was a maintenance of a strong structure at the SEC, and this at a time when we saw the proliferation of markets in Chicago and maybe a lot of problems that came out of that. We saw the S&L issue. We are seeing a lot of other issues. And I think that consistent with that, Mr. Chairman, we have a responsibility to look at these two issues again, the relationship of the two marketplaces and having one regulator and looking at the subsidiary parent relationship that you-all are involved with, and you have been discussing as well, Mr. Downey.

I hope we can do that, Mr. Chairman. Thank you very much.

Senator Dodd. I would say to my colleague, again, Senator Heinz and I made written requests, several months ago on both of those issues. The answer was supposed to have been provided to the committee, in fact, last week, but Chairman Breeden has asked for a little more time on that, because there are significant discussions apparently going on among agencies that would be affected by a decision, but we have been pushing on both questions, the margin requirements and the single regulatory body. We have had, of course, significant discussions, debate, and a markup, in fact, on the question of risk assessments information in the Market Reform Act and related matters before the committee. So we agree with you, pushing on in those fronts. I think it is fascinating history with the CFTC, how it was created. It was created because the SEC didn't want it. The SEC could have had jurisdiction and the problem could have been resolved a number of years ago, if my history is correct on it.

Chairman Riegle, I would tell you, we have had nine members here this morning participating. We are just completing our first line, so I welcome you back.

Senator **Riegle**. Thank you very much. Let me just say with respect to this last topic and the points that Senator Wirth raises. We have got Gerald Corrigan scheduled to testify on financial modernization and the other adjustments that he may want to recommend on May 3, and then we've got Treasury Secretary Brady coming in on the same subject on June 8. So we are coming down the track building that body of contemporary opinion from those various management points, including what we are hearing here today.

I want to raise a question here about conflicts of interest, and I want to pose it with respect to two important comments we have gotten before the committee.

Professor Hayes, who is going to be testifying later this morning, writes about the increasing preoccupation of U.S. investment firms with managing their own investments and says as follows in his testimony today. He thinks that practice is:

> Raised conflict of interest questions that have driven a wedge of wariness and suspicion between themselves and their traditional corporate clients and institutional investor customers.

And then last Friday at this table we had Jerome Kohlberg, who I think you all know personally, who testified before the full committee, his view that conflicts of interest "permeating many transactions," clouding the judgment of the securities firms involved. He noted that firms often represent and receive fees from both buyer and seller in the same transaction, and further that these fees are usually contingent upon the completion of the transaction which may influence the judgment of the investment banker when issuing fairness opinions.

And I am wondering how each of you feel with respect to that assessment by Mr. Kohlberg that conflicts of interest are present today in the securities industry and are something that we should be concerned about.

Mr. Gutfreund, what would be your reaction to that?

Mr. **Gutfreund**. Senator, he took a big swipe there, and there are undoubtedly conflicts of interest present all the time. There are conflicts of interest in everything you do. Life is complicated. I do think the idea of getting fees from both sides and talking about a fairness opinion, which is a technical term, says the price paid or the price offered is correct or within boundaries of being correct. We don't get many opportunities to represent both sides, and we don't think that a fairness opinion is necessarily feasible, representing both sides.

I would disagree with Mr. Kohlberg that that is common practice. It is not common practice by us; I don't think it is common practice by any of these firms here. You don't represent both sides, and you don't give a fairness opinion in that circumstance.

Senator RIEGLE. Let me just ask you at that point. I mean, that may well be the practice among yourself, as you testified, but if others are doing that, should that be something that we should try to stop or should be stopped? I take it you are not saying none does it, you are just saying you don't do it.

Mr. GUTFREUND. As a matter of opinion, yes. Just one opinion.

Mr. SIMONS. How many cases can you think of where somebody represented both sides? I can't think of any.

Mr. PURCELL. Neither can I.

Mr. DOWNEY. But if two corporations want to get together and make a merger and want someone to come in as an honest broker and help them and don't want to—you know, incur the extra fees for hiring additional investment bankers, I don't see why they should not be allowed.

Mr. GUTFREUND. That's not a conflict of interest.

Mr. DOWNEY. No, I agree. But I am just saying there are cases of that.

Mr. GUTFREUND. So the definition has to be pretty close.

The other issue of conflict in terms of our own investment and fee motivation, that is a very difficult issue. I think all of us in searching for a competitive answer to what was happening to some of our competition in the eighties, went to principaling almost kicking and screaming, at least in my case. The greed factor moved us into that. The conflict that relates to that is inherent and oftentimes explicit. I think that a lot of that may have been cured by the events of the last year. But I don't know how one should think about it from a Senator's point of view. I don't think there is anything to legislate there. I think that a normal corporation is relatively aware. They have legal counsel; they have good financial officers. I think they can probably handle it. I would not think I would want that put into codification, if that is the right term.

The conflict, though, is well understood by all of us, and clients of ours make certain that we do understand if we don't.

Senator RIEGLE. Bob.

Mr. DOWNEY. I think John has covered it very well. There is no question that the pressures of the eighties, of the, you know, highly confident letters and so forth, drove other competitors to say, "Well, I'll put up the money directly, and therefore, we're in the game as a principal instead of just a, you know, an adviser or underwriter." And that certainly is a concerning thing.

Senator RIEGLE. But I am wondering if we want to continue to go down that track. I mean, it is one thing if you say, well, the game's changed now, and so that is sort of passe. It's another thing if you've got reservations about it and it's going to continue.

I am wondering should an investment firm receive fees for advising on a transaction and at the same time be permitted to invest in the same transaction? And where does the conflict—where should we draw the conflict line here?

Mr. DOWNEY. As participant in the transaction?

Senator RIEGLE. Yes.

Mr. DOWNEY. I am not sure that's where it should be drawn, Senator. I think that, as John says, the conflicts come up every day, but to prohibit an investment banker from investing in a situation I am not sure is the answer.

Mr. GUTFREUND. I have a feeling that to codify anything here, you have to use some common sense, because the rest of your business, it is as if somebody accused you of systematically ripping off your clients. How could you maintain your business if you were doing that? So there's a common sense part of it. I have a feeling that any law here to be drafted would be extremely difficult and probably have as many bad effects as good ones.

Senator RIEGLE. Yes. I am not thinking so much in terms of a law, although, you know, that it would be one way to do it, as opposed to the regulatory bodies establishing some guidelines or some conflict rules here, because, you know, you are sensitive to it, as you yourself has just said. It is something that you have thought about and that you haven't been comfortable with coming through part of the eighties, and maybe it self-corrected and maybe it hasn't.

Mr. GUTFREUND. Another question is, you never know who is hurt. It may be a victimless whatever it is, [Laughter.]

Or the victim may be yourself, as I indicated. We've shot our own foot off more than once with this kind of circumstance.

Senator RIEGLE. Let me just ask one other thing. I noticed that Thomas Strauss, who is the president of Salomon Bros., called last month for the repeal of Glass-Steagall, the repeal of the McFadden Act and the repeal of the Bank Holding Company, which, of course, would let the banking——

Mr. GUTFREUND. Just a bit of rhetoric. [Laughter.]

Senator RIEGLE. Well, how do you feel about——[Laughter.]

Mr. GUTFREUND. Obviously, we've talked about it. Mr. Strauss and I are still very close——[Laughter.] And I would agree that over time a number of these boundaries have become improper and ought to be changed. He was trying to be provocative, and I am glad he reached an audience. We do think these things ought to be changed over time.

Senator RIEGLE. Well, that doesn't sound to me like you're saying you'd be happy to see the whole thing—see all three repealed this afternoon.

Mr. GUTFREUND. Well, the question is, what do I get for it on the other side? I think we could live with that, but the real answer is that the level playing field issue underlies a lot of this. It seems that when you talk about this kind of removal, and you eliminate deposit insurance, you eliminate firewalls, you got a lot of things going there, where I don't think we can—I said this in my prepared testimony.

Senator RIEGLE. I am just looking at that right now.

Mr. GUTFREUND. I don't think we have the ability, having grown up with the Ten Commandments or their equivalent, to operate without any sense of rules, order, very tough for us. And I think, fundamentally, the system would be highly destabilized if we went to this in one quick step. We don't operate well without rules. If we are going to change them, we ought to change them deliberately. Some of them ought to be changed because they are antiquated, and we think that, for example, the situation of the banks being in the securities business with certain caveats, that's fine, if that's more efficient. It seems to be the public conception that it would be more efficient, lower cost of capital, better markets. I don't necessarily believe this. but if people want to try it, let's make sure it's done fairly. That's all we're saying.

Senator RIEGLE. Mr. Chairman, my time is up. This question of whether or not we make those kinds of sweeping changes in the name of a level playing field or a financial deregulation or modernization or responding to global competition, I think is really at the center of much of the work that you've been leading.

I don't want to delay my period here one way or another. If there's an interest, I would like to know if the others have anything——

Senator DODD. I presume Mr. Simons may have a point of view a little bit different, being a regional firm. If you would like to respond to it, because that was certainly a legitimate question for you. The obvious concern is, are you going to be able to compete in that kind of a market.

Mr. SIMONS. We're dancing among elephants, Senator. [Laughter.]

Strangely enough, we totally endorse the Securities Industry Association position.

Senator DODD. That's a little different than what Mr. Strauss is suggesting.

Mr. SIMONS. Well, I think, as John said, that was some rhetoric to provoke people, and it would provoke me. [Laughter.]

Senator DODD. That's what we're interested in hearing today. [Laughter.]

Mr. SIMONS. No, I don't agree with Mr. Strauss' position on complete deregulation. I think it ought to be examined thoroughly along the lines that John touched on. It's got to be done carefully. I think the SIA spent a lot of time on this. I happened to have been on the committee that studies this over the last 2 years at the SIA. There were three investment banking firms, three wire houses and three regional firms, and we basically came up with a plan in the last 4 or 5 months that Bob went over briefly in his testimony, and has stated further, and I think it is a very sound plan and a way to move forward in this area on a proactive basis.

Senator DODD. Bob, do you want to comment on that?

Mr. DOWNEY. The Banking Act of 1933 had several sections: but the two most important from our perspective were Glass-Steagall and Insured Deposits. And the interesting thing is, what our plan does in its simplest form, if it were not that the 1933 Banking Act had a deposit insurance section in it, we would be advocating, as John says, the repeal of Glass-Steagall in our proposal. The fact is, deposit insurance is in the Act, and it has cost this Nation $200 to

$300 billion in the S&L failures and who knows how much more in banking failures and in future banking failures. And that is what we are saying is silly. But we will get rid of Glass-Steagall when we can find some way to get the Government out of the competition, and not just because it's unfair competition on the level playing field. There's no love going to be wasted on the securities industry if we get beat up by unfair competition, but it sure makes no sense to punish the taxpayer and to have the banking bailout bill of 1992, or 1993 or whatever, because they got into junk bond underwriting, just like we've had the S&L bailout bill of last year because they got into new activities whether it was, you know, raw land investments or other kinds of, I don't know, investing in hotels and speculative developments whatever the heck they did. And so deregulation certainly is not the answer unless it also means privatization. And John has indicated this as well. I think we are closer than it may appear to their provocative comments if they mean full privatization. Our key is privatization. Then the banks can come in and compete with us in any way they like, but let's keep the government out of it.

Mr. PURCELL. I would just add that we have been a long-term advocate for restructuring the regulatory mechanisms in all financial services and welcome Mr. Gutfreund and Mr. Strauss to the debate. [Laughter.]

Mr. GUTFREUND. Is that under the name of Sears or Witter?

Mr. PURCELL. Both. They're the same. [Laughter.]

And as I said in my remarks, we advocate a form of functional regulation similar to—not similar to, but as contained in S. 530 and think that it would bring capital to the financial services businesses, all of them, and we know that we need more capital in financial services businesses, and it will make us more competitive, globally, and it is structured in a way that in my judgment makes the level playing field among banks and securities firms. So we would advocate that. Implicit in that bill is some strengthening of the regulation of bank capital requirements, which we also advocate, but we agree with John that to try to do everything at once, as contained in Mr. Strauss' paper, would be a little bit unsettling.

Senator DODD. Let me pick up on that point a little bit with you. You know, we saw the drop in retail commission sales, and what replaced that was free from mergers and acquisitions. Now you, Phil, have talked about the increase in equity markets. What makes you say that?

Mr. PURCELL. When I said that I thought equity financing would be the product of the nineties?

Senator DODD. Yes.

Mr. PURCELL. Well, I see a number of things. First of all, I think that, as John Gutfreund has remarked, that we are at the beginning of seeing the impact of the overleveraging of companies and the refinancing of companies with debt, and we are also at the beginning, in my judgment, in financial services of requiring greater capital strength. And those two trends, to me, are going to wake up all of the management and the boards of directors in America to the need to be soundly financed, and we will go back to financial ratios closer to what were historic than what we saw in the late eighties, and that's what I'm basing my judgment on.

Senator DODD. Do you expect to be competitive when you've got a 16-percent equity base and Japanese firms only a 6-percent base? I'm using statistics from our next panel.

Mr. PURCELL. Well, if we wanted to have hearings on turmoil in equity markets, we should have them in Tokyo. They're having their own problems too, and I do not forecast that kind of a difference between our market and their market through the nineties, just as if you went back 20 years into the sixties, our market sold at 30 PE's, while Japan's sold at 3 to 5, and that didn't stay either. So I don't take that as a constant state of equity affairs.

Senator DODD. Yes. Anyone else want to comment on that question?

Mr. GUTFREUND. I've talked enough.

Mr. SIMONS. Senator, I think the individual investor is interested in investing, and I think Phil's—that's one of the things he's kind of touching on. I think the individual investor wants to invest. He is still active; he's still there. His confidence is shaky.

Senator DODD. I understand that. Phil quoted the statistic that today the individual investor still comprises 50 percent of the market, 43 percent on the institutional investor. But that number offers no assurance whatsoever, because, as we have been talking here this morning, that number's changing. In fact, the percentage of involvement by the institutional investor is increasing dramatically, and the predictions are that by the middle of this decade, you are going to be looking at a number—someone quoted a number closer to 60 percent of the market being institutional investors. I don't know whether you see those trend lines yourself, and I think we've talked enough today about how you bring back the individual investor, but those trend lines are disturbing.

Are those trend lines correct?

Mr. PURCELL. Those would be projections. Yes, I think that they underestimate what is starting to go especially with equity mutual funds.

Senator DODD. Yes.

Mr. PURCELL. The individual investor started to come back before 1987 into equities and sort of reversed the trend lines that we're all so familiar with, the crash in 1987, the market drop in 1987 reversed all that.

Senator DODD. Yes.

Mr. PURCELL. We're starting to see just in the last 6 months the individual come back into equities very strongly through mutual funds rather than through individual investment, and those trends are very, very strong.

Senator DODD. Yes. I have heard that as well.

Let me quickly get your quick views on the program trading, and I forget whether it was you, Mr. Simons, or you, Phil, I don't know who mentioned it, but the point was that program trading didn't create the problem. Program trading can exacerbate a market decline, but the notion somehow that program trading created the situations in 1987 and last year are, in my view, incorrect. Obviously, you can't go back to shoeboxes. If you are going to have significant involvement, by institutional investors in the market, you're going to have to use the technology today or you are going to be in an impossible situation.

There have been a number of suggestions made in connection with the market reform legislation as to what we ought to say about program trading. Someone suggested the extreme, abolishing it altogether. I suspect that none of you here embrace that view, but I would be quickly interested in just a quick response as to what you feel we ought to be saying about program trading. Bob.

Mr. DOWNEY. Again, having spent 30 to 40 hours on it just in our study alone, we haven't concluded exactly where we should be on it, except with respect to the one regulator, with respect to the coordination of margins, the harmonization of margins and, of course, working on the clearing systems. Beyond that, how those coordinating——

Senator DODD. What about a 20-minute delay or something?

Mr. DOWNEY. Well, those are exactly the things we are working on now in our program trading committee meeting. We are going to bring this to our board next week. I would be able to answer that one a lot better a week to 10 days from now.

Senator DODD. Could you let us know on that?

Mr. DOWNEY. By all means.

Senator DODD. All right. Do you have any ideas?

Mr. SIMONS. No.

Senator DODD. Phil.

Mr. PURCELL. Just the things that I have said already, Senator. John and I are on a blue ribbon panel for the New York Stock Exchange that is studying what can be done about program trading, and I would endorse the single regulator and the control of margins. Then I would wait to see what that committee comes out with, together with what the SIA is saying, because the exchange has been very progressive in trying to solve the access program for the individual investor and to slow down the price adjustment that is the real problem between the two markets. And I would give them a little more time and see what this blue ribbon panel comes up with. And I think it is a problem that is going to be with us for a long time, and we are just going to keep making little adjustments until the market is smooth, just like we with block trading in the sixties. It took a long time for block trading to not disrupt markets. And I think it will take us quite a bit of time to get program trading not to disrupt markets, but we will get there.

Senator DODD. Last, I mentioned already that Senator Heinz and I will be in Europe meeting with our counterparts over there. Speaking for both of us, we would deeply appreciate any suggestions or ideas or questions that you think we ought to raise during that series of meetings. I know that our staffs have been in touch with yours on some of this already, but I raise it again today with you. We are very anxious to carry that message and the concerns like the United Kingdom firms' concerns about capital levels. That's just the kind of thing we want to raise, but there may be some other points.

Mr. DOWNEY. Well, Senator, we think it should be included as part of with the next GATT session in Uruguay, some of these issues, because of the fact that the European financial system is so governmentally supported for securities and banking and all of it operates far differently than ours. And if they have advantages in other industries—they have tremendous advantages in financial services industries, and it really hasn't been fully discussed.

Senator DODD. Have you expressed that view?

Mr. DOWNEY. We have to the Federal Reserve.

Senator DODD. That's a good point.

Does anybody have any additional questions?

Senator HEINZ. I have one that is really related to what you just asked, Mr. Chairman. If you look at what is going on in the European Community and the Second Banking Directorate, they have a model that looks different from ours. They have a tank and we have something else. An armored personnel carrier or a jeep or a tricycle. But in theory if everybody operates under the principles of national treatment, in theory, in each country no institution is at a disadvantage. The question is, is that true in practice?

Mr. DOWNEY. Or do they really have another agenda which is not national treatment but is in fact reciprocity.

Senator HEINZ. Let me put the question this way. How does the policy of national treatment affect our ability to develop a structure that is compatible with American ideals? If we do it our way, can we compete, whatever our way is? To what extent must we reform Glass-Steagall, or the McFadden Act and so on and so forth.

Mr. GUTFREUND. It's very tough for a pluralistic kind of system that we have to compete with a partnership that starts with a government, a central bank, the commercial banks, the ownership of the companies in large part, the institutional ownership away from the banks themselves, the funds owned by the same banks. That is very difficult for us to compete with.

Mr. DOWNEY. And I think we have to be advocates for the American system. I mean the reason that Eastern Europe is crumbling is because State-owned systems ain't so hot and private systems seem to be the way that really works. So everybody seems to be giving us a vote, and I think that our Congress ought to advocate our system, which is privatization.

The SIA plan is good, for example. If you take deposit insurance off to the side, we can complete and we can have all kinds of tie-ins and so forth, but we're just not going to have the Government involved. But it is going to be tough to compete with them if they are all going to be Government based or supported. There is no question about that, and I think we have to advocate an international system that keeps the financial services industry private.

Let me ask only one somewhat related question, and then I'll be through, Mr. Chairman.

Over the last 10 to 15 years the securities industry has reduced its reliance dramatically on commissions as the source of its revenue. It used to be 60 percent and it's now down around 17 percent. That has been replaced by what we might call risk derived activities, securitization is one aspect of those.

Do you see the heavy reliance on risk based revenues continuing into the 1990's and, if so, what are the implications for the stability of our financial system and the adequacy of our regulatory oversight of the securities industry? It seems to me that is what Drexel is kind of asking us to ask you.

Mr. DOWNEY. From the grave.

Mr. GUTFREUND. On that basis we have a hell of a problem. [Laughter.]

You know, the question is the——

Senator HEINZ. I hope you will make it clear to the press it's metaphorical.

Mr. GUTFREUND. It is metaphorical. The consequences of deregulation are deregulation, and that is the fixed commission. If you look from May Day 1975 to 1990, the retail investor has not been particularly advantaged by it unless he is willing to pool his investments by the reduction of commissions. He continues to pay a relatively high commission, cheap in relation to the good service he gets and the value he may get, but it's very high.

One of the problems is what are we going to do to stabilize industry where there are no fixed rates? I think you will see it in the stock prices of securities companies, you will see it in the volatility of their earnings, and you will have a destabilized environment for some period of time.

Senator HEINZ. The next panel, which is Mr. Lipper and Professor Hayes of the Harvard Business School, is going to argue I understand that when a securities firm acts both as principal, which are these risk-based activities, and as agent either to the retail customer or to the corporation you advise, that the security firm necessarily loses objectivity because of conflicts of interest, theirs versus their clients.

I would like to give you a chance to respond to that point of view. Do you agree with that observation and, if so, should it be remedied and how, and if not, fine.

Mr. GUTFREUND. The answer was implicit in my answer to the last question, that when you have no fixed commissions people are going to be opportunistic, innovative, creative and they are going to find ways to place themselves in the middle and there is no question about it that there are conflicts inherent, but there are conflicts again, as I said to Senator Riegle earlier, in almost everything we do in every business activity.

I do not see an easy and ready answer. You can go from the Dean Witter position, which is a very, very good service provided on a large scale for public investors, be they pooled or individual, to something at the other extreme, which is almost totally institutional, but even they are under pressure for margins.

Mr. PURCELL. I mean to me the movement to the principal world for securities firms came as the margins disappeared in all of our traditional businesses and we had overcapacity and we priced ourselves to be profit proof in those lines of business.

Senator HEINZ. The same thing happened to banks and S&Ls.

Mr. PURCELL. And that's how you get into risking your own capital for yourself as opposed to for your clients. I think one of the great strengths of this industry has been its ability to adapt and figure out a way to survive and make money in each succeeding new environment, and we are just beginning in this principal environment. This is a brand new world for us. It has really only been going on for 2 or 3 years.

I think the question of conflicts of interest is on the mind of every major person in the securities business as to how do you set internal policies and rules to behave right and to not put your own interest ahead of your clients, and it will take time to work out.

I agree with John Gutfreund in answering Chairman Riegle that it's not something that can be legislated or codified, but it is something that every firm must deal with, and we are just beginning to.

Mr. DOWNEY. I would like to make just a little comment on that, too, Senator, if I may. It is true that the margins have been compressed and that has squeezed a lot of securities firms into principal trading—I should say not principal trading, but trading in investments that might be considered merchant banking and so forth. And when you go that far, not only has John's firm done it kicking and screaming, but so has ours and so have many others, but it may be the reality of the 1990's.

Mr. GUTFREUND. That's the one club you didn't need to join.

Mr. DOWNEY. That's for sure.

Mr. PURCELL. It's an expensive club.

Mr. DOWNEY. We only joined it in a couple of cases where due to competitive pressures you have no real choice if you want to keep your client. But I think we ought to not lose sight of the firms that have just stuck to their knitting and done very well. J.C. Bradford and A.G. Edwards and similar firms have not gotten into the principal business, they have been serving as agents and even in spite of all the pressures and deregulations have done it quite well.

That's also true in the S&L business. The firms that stuck to their knitting and did home loans did an awful lot better than those firms that went out and joined in the new happy hour of investing in raw land where the nation had to come back to pick up the tab.

Senator HEINZ. Very well.

Mr. Chairman, thank you.

Senator DODD. Thank you.

Gentlemen, I have taken a lot of your time, going on 3 hours. That's a long time to ask people to sit before a table in a committee hearing, but it has been tremendously helpful, and you have made some very fine suggestions and observations as we look at the condition of the market

On behalf of the entire committee I want to thank you, and the fact that we've had some 10 Senators here this morning I think indicates the kind of interest there is in the subject matter that you've brought before the subcommittee.

We look forward to an ongoing dialog, and obviously any additional thoughts or comments you may want to submit to the committee as a result of today's hearing, we would more than welcome.

So on behalf of my colleagues here on the subcommittee, and I'm speaking I'm certain for the full committee as well, we thank you for being with us this morning.

On our second panel, which has been a very patient panel, is Samuel L. Hayes III, the Jacob H. Schiff, professor of investment banking at the Harvard Business School and Michael Lipper, the president of Lipper Analytical Services, Inc.

Well, Mr. Hayes and Mr. Lipper, look at it this way. You've had the benefit of hearing from four previous witnesses. So you feel free to tailor your remarks accordingly, which obviously you may want to do.

I have included your statements already as part of the record, the permanent record, and it might be of some help if you would paraphrase those remarks, and we would appreciate immensely if you would pick up on some of the comments that have been made. I took the liberty of using some of your statistics, at least in one question anyway, to raise the issue of equity financing and the competitive problems we face in that regard.

So again we appreciate your involvement already in this hearing and look forward to your statements and responses to questions that we have for you.

Mr. Hayes, we'll begin with you.

STATEMENT OF SAMUEL L. HAYES III, JACOB H. SCHIFF PROFESSOR OF INVESTMENT BANKING, HARVARD BUSINESS SCHOOL, BOSTON, MA

Mr. HAYES. Mr. Chairman and other Members of the committee, it's a pleasure to be here and in such distinguished company.

Because of the late hour, I will try to shorten my remarks and to try as much as possible to supplement rather than to repeat what I have already presented in my written testimony.

I think that the messages come through loud and clear from the previous panel that they do not see the current dislocations in the securities industry as a business in extremis and on the verge of extinction.

Senator DODD. That's putting it modestly.

Mr. HAYES. And in fact that's my conclusion as well. From the ivory towers up in Cambridge it looks still like a very healthy industry. It looks like an industry that has in fact accomplished a lot over a relatively short period of time, and in my prepared remarks I draw the size distinctions between these firms' number of employees in the early 1970's versus the beginning of the 1990's; a firm might have had 250 employees in 1972 now has 6,000 employees, and a firm that might have had $10 million in capital now has $2.65 billion in capital, and a firm that had a single office on Wall Street now has outposts all over the world with as many as 600 and 700 hundred employees in some of the branches. This is an extraordinary development that has taken place in the industry.

My remarks are going to focus primarily on the wholesale side of the business. The retail firms who were represented in the first panel are an important element in the business. But they represent, in my opinion, a declining part of the market, and ultimately an endangered species. While there will still be a significant individual investor clientele for the next several decades, they will come less and less important. The statistics that we have heard indicating that more than half of the wealth is still in the hands of individuals is misleading. In the actual buying and selling back and forth, institutions typically make up 80 to 90 percent of the market.

I think we should be looking at the world class competitors who are the leading edge of competition in the securities marketplace of the 1990's. There are six dominant firms. Two of them are represented here today.

Senator RIEGLE. Excuse me. Would you allow him to yield just for one passing question here because you raise a very interesting point. The Dean Witter witness said that 57 percent of the securities outstanding are held by individuals and 43 by institutions. You just said that's not the relevant thing to look at, but it's who is generating the business activity each day and it's overwhelming dominated by the institutional investor.

Given the fact that both those facts are apparently true, and you don't dispute his statistics on the front end——

Mr. HAYES. No, not at all.

Senator RIEGLE. Why is it that you argue that who does the trading is the critical issue as opposed to who actually owns the securities? If 57 percent are still held by individuals, why are they a dying species when they are more than half of the total?

Mr. HAYES. Well, that's a good question, and I guess the answer is that there has been a steady liquidation of that percentage all through the post World War II period, and it has been accelerating. People who hold shares are finding that they are like a VW Rabbit on a superhighway surrounded by 18 wheelers. They are outclassed and they are outgunned. They can't get a fair shake even if the big players are playing by the rules because of the nature of the marketplace and the muscle which these institutional investors have to bring to bear.

So, therefore, I think that the move to institutional investing and toward mutual funds is accelerating and that we will see this as a continuing trend.

Senator RIEGLE. Thank you for yielding. I have trouble with that analysis, but that's a separate matter.

Senator DODD. And you're suggesting not necessarily a bad trend.

Mr. HAYES. No, not necessarily bad but, on the other hand, not totally within the spirit of this populist country's traditional philosophy.

Senator DODD. Is it sort of like a family farm?

Mr. HAYES. A family farm may be a good analogy. I think that the defense of the small investor, the small businessman or woman is deeply embedded in our culture and has a great deal of political appeal; I think that it's going to be difficult for us to manage the transition from an individual investor-dominated marketplace, which we were in the 1950's and before, to an institutionally dominated investor world, which we will in the 21st Century.

Senator RIEGLE. Could you yield just for one more point on this.

Senator DODD. Certainly.

Senator RIEGLE. This is interesting and important I think. If I'm not mistaken though, most of the institutional money managers of mutual funds don't beat the Dow Jones average. In other words, they charge a fee, and yet they don't manage to do as well as the Dow Jones averages do.

Now if I'm an individual investor and I've got to decide whether I want to try and pick the stocks or pay somebody else to pick them who on the average isn't going to beat the Dow Jones average, I don't see why that creates an inevitable move toward the institutional investor.

Now maybe you do a regression analysis that shows that we're really going to see the individual investor disappear, but I'm just not sure given the performance levels of money managers that's necessarily going to be the case.

Mr. HAYES. Certainly, Mr. Chairman, from a logical point of view you're absolutely right, but I don't think that is the way in which the business has behaved.

There are two forces that I think have been at work here to push this institutionalization. One is the individuals fear, that he/she won't be able to operate successfully as an individual in the marketplace. The second is the marketing efforts undertaken by institutions to promote their products that there has been a great deal of marketing of these to individual savers. I don't think mutual funds are bought, I think they are sold, and I don't think the individual's purchase of mutual funds is typically highly correlated with fund performance.

So I think that while you're absolutely right in a logical sense, I think that the numbers and the trends tell a different story.

Senator RIEGLE. Thank you. I appreciate the chairman yielding.

Mr. HAYES. Well, to continue, the large, dominant firms, and I have indicated there are only six of them in the United States, are now global in their perspective, have outposts all over the world, and have been prolific in the way they have built their size and their scope. And in the process of this, of course, it has been difficult for them to rely on the same informal control which were used to manage these firms in the past.

When you have 6,000 employees, you simply can't give the personal oversight that you would like to. So you tend to want to build a whole corporate oversight structure, a multilayered bureaucracy that can assist in managing such a large and diverse organization.

But the fact is that most of the leading firms haven't done that. In fact, they have maintained very decentralized organizational structures with a lot of people reporting to a very few top managers. And while you might be critical of this there have been some studies suggesting that the really creative investment bankers operate best environments which are unstructured. They operate with a lot of leeway, where they don't have to keep checking every time they tie their shoe laces. The investment banks have recognized in their organizational structure, that they tread a very thin line between, entrepreneurship and bureaucracy.

Several people have talked about the importance of the New York capital market, and in fact some of your questions have been directed at trying to preserve the New York market. I would like to suggest that with the increasing globalization of the markets, it's not as relevant to talk about the New York market standing independently. It's more relevant to talk about the U.S. securities industry, U.S. vendors and how they are doing in the global market. The global market is like a giant electrical grid, and when you plug something in at anyone point it courses throughout the system.

The U.S. securities industry does have some important problems, and many of them have been touched on either by your questions or by various comments made by the first panel. I would like to comment on several.

The first is that when you grow "like topsy", you often don't maintain control over your costs, and I think that one of the major problems which these investment banks developed in the 1980 was a bloated overhead. It has required a much more drastic pruning and cutting than would have been the case had they begun to trim at an earlier point. But investment bankers are entrepreneurs. They respond to opportunity. When the opportunity is there, they go after it. They allowed expenses to get somewhat out of control on the upside and they now have to suffer the consequences on the downside. And the consequences have been serious in at least two areas.

They have, for instance, given a lot of capital and responsibility to a few individuals in the trading area, and this has caused them some serious problems. There are some examples of hundreds of millions of dollars lost by one trader in 2 weeks or less and wiping out the profits of another major part of the same securities firm. In fact, that situation repeatedly led Wasserstein and Perella to leave First Boston.

The second area is insider trading. When you have a very large organization, it is tougher to foster a sense of identity with the firm and a sense of responsibility for protecting its long-term interests.

And in a group of 3,000 or 4,000 professionals, you are likely to find some people who don't have the kind of ethical standards that have in the past been associated with the investment banks, and I think that this has been a very serious problem for the firms. They are trying very hard to deal effectively with it.

The last thing I want to mention has already been raised by the chairman and I think by Mr. Dodd, relating to the shift in the role of the U.S. investment bank from being essentially a counselor and an agent for various constituencies to one increasingly preoccupied with managing their own capital.

I suggested in my written testimony that the conflicts of interest which result are unavoidable, and that the investment banks have for the most part tried very hard to deal with that problem and to form rules and regulations which will protect the interests of others.

However, it's my impression from my contacts that various of their clients and customers have concluded that these conflicts of interest are irreconcilable and that as long as these investment banks are going to serve in this altered role that these clients and customers will have to make their own arrangements to protect themselves.

I think therefore that there is a vacuum being created, a dearth of professionals on Wall Street able to fulfill the role of corporate counselor.

It is ironic that the investment banks have enjoyed the luxury of being the primary financial counselors in the United States since World War II. In sharp contrast, the Japanese securities firms, particularly the Big Four, have been on the outside looking in while the city banks, which are like our commercial banks, have been the primary financial counselors. So at the very time that we find the Big Four brokers in Japan trying to build corporate relationships in emulation of the United States investment banks, the United States firms are abandoning that role in favor of profits available from acting as principal.

As we look ahead to the 1990's, (and I only have a couple more comments to make), that the investment banks are at a real crossroads. They have gotten to a size where many of these problems are likely to persist.

When we heard the first panel talking about how they were striving to deal with these problems, they admitted they didn't yet have solutions for many of them. And they are being pushed by global forces to become even larger and more diverse and thus even more vulnerable in these dimensions.

Now what is it that Government should or should not do in a situation like this? My own conclusion is that you can't productively do a lot in a legislative sense. I think that both the corporate and institutional investor sectors can take care of themselves.

I think that the kind of careful questioning that you've been undertaking this morning is excellent. You want to better understand the dynamics of how this business operates, and where are the areas that can or cannot be allowed to be worked out by the marketplace.

I think that it's very important that the markets be perceived as fair by the public.

Unfortunately, the marketplace is not perceived as fair by many, and the questions raised with the first panel about volatility are very much to the point. In addition, I think there is a sense that there is misuse of position and misuse of information. This creates a situation in which there will be more pressure on Congress to do something, to respond to what they see as the inequities.

I think that the enormous compensation that has been paid in the Street for the last decade should be a real embarrassment to the Street. But there is little that can be done directly in a legislative sense.

Thank you for your attention.

Senator DODD. Thank you very much, Professor Hayes, and I couldn't agree more with you on your notion of the perception of fairness and confidence in the markets.

[The complete prepared statement of Professor Samuel L. Hayes III follows:]

Testimony before the United States Senate
Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities

March 6, 1990

Samuel L. Hayes III
Jacob H. Schiff Professor of Investment Banking
Harvard University
Graduate School of Business Administration

Mr. Chairman and other esteemed members, I am honored to join such a distinguished group of securities industry leaders in testifying before this Senate subcommittee and greatly appreciate this opportunity.

From the tone of recent media coverage, you might well conclude that the U.S. Wall Street vendor community has been going to hell in a handbasket! Certainly, the sudden collapse of Drexel Burnham (a focal point of public attention for much of the 1980s) adds credence to that image. But from my point of view, that perception is misinformed. To paraphrase Mark Twain, reports of its death are greatly exaggerated!

This is not to deny that the Street is going through a consolidation of the great growth which it has experienced over the past decade or more.[1] There is a lot of blood on the floor and there are indeed bodies littering the battlefield. And the whole thing has been complicated by a series of public relations disasters unparalleled since the Great Depression.

But when you step back and view this in longer-term perspective, the picture looks much less bleak. The fact is, a group of about six dominant U.S. wholesale investment banks (the retail sector is a separate story) are the world-class competitors which virtually every other national group of public market vendors is trying to copy. This group includes First Boston, Goldman Sachs, Merrill Lynch, Morgan Stanley, Salomon Brothers and Shearson Lehman Hutton. These firms have had a long run of growth years, and are now experiencing all of the unpleasant aftereffects of such an extended and exuberant party. Getting over this hangover isn't without pain.

But the firms are also using this period of consolidation to do some pruning and restructuring of their international organizations, a process which at an earlier point would have been more risky from a morale and external public perception point of view.

The more important longer-term questions facing the Wall Street wholesale firms relate to their future trajectory:

1. Will they be able to maintain their broad, full-service

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[1] S. Hayes and P. Hubbard, 1990. Investment Banking: A Tale of Three Cities, (Harvard Business School Press: Boston).

portfolio of activities of the past, or will they decide to specialize in one or more niches that offer the most lucrative near-term profit payoffs?

2. Is there an upper limit to the size and diversity of an investment bank beyond which it ceases to be the entrepreneurial catalyst that has been its hallmark in the past?

3. Where will its future competition come from?

The Investment Banking Transformation

If, like Rip Van Winkle, some of the leaders of the U.S. investment banking business active during the sedate 1950s and 1960s had gone to sleep for several decades, to awaken in 1990, they would be astounded by the changes in the intervening period:

- More than half of the firms they dealt with have disappeared either through merger or liquidation.

- Those that remain are no longer organized in the neat pyramidal power structure that was so distinctive twenty years ago. Now, there are roughly half a dozen dominant firms (all of whose names they would recognize, to be sure), a handful of more or less successful "niche" players and then "everybody else".

- The "syndicate system" by which the leading investment banking originators ("wholesalers") parceled out new issues of securities like patronage to grateful constituent retail brokerage firms is a pale shadow of its former self. The distribution of securities has become much more narrow and concentrated than in the past. Power on Wall Street, which used to be exercised through syndicate leadership, is now exercised in other ways.

- The surviving firms have, for the most part, become huge organizations relative to twenty years ago. Instead of their single-product concentration on the periodic underwriting of a corporate client's new stock or bond issue, these firms are today devising and merchandising a myriad of products. Employees barely recognize many of their co-workers within the same firm and management finds it next to impossible to monitor and control them via the traditional "visual oversight" of sharing the same workspace that worked so well for the Rip Van Winkles of the 1960s.

- Instead of a single office, the surviving firms of today are positioned all over the world. Some of them now have more employees in London than they had in their entire firm at the end of the 1960s.

- As a consequence, there isn't the loyalty to the firm and to the firm's long-term interests that was once a "given". Personal self-interest has brought both an escalation of compensation packages as well as embarrassing breaches of trust.

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- As a consequence, there isn't the loyalty to the firm and to the firm's long-term interests that was once a "given". Personal self-interest has brought both an escalation of compensation packages as well as embarrassing breaches of trust.

Nonetheless, the newly-awakened Rip Van Winkles would have to extend at least grudging admiration to this handful of leading investment banking firms for their positioning as they move into the 1990s. They are, after all, the world-class vendors that everyone else in the U.S. and abroad seeks to copy. Their skill in spotting change and exploiting trends early on has put them in an enviable position in a number of lucrative and still-growing market niches, and their "rocket scientists" have devised and promoted so many esoteric hybrid securities for various clients that the old "plain vanilla" debt and equity offerings that were the staple of the earlier investment bankers now look like child's play - and are compensated accordingly!

While the newly-awakened bankers would be assaulted at every turn by media coverage of apparent volatility in the stock market, defaults in "junk bonds" issued at the investment bankers' urging, entrepreneurs jumping into the frenetic leveraged buyout (LBO) movement, and by the series of Wall Street layoffs that never seem to end, they might also observe that the more things seem to change, the more they seem to replicate past cycles. J.P. Morgan and Jacob Schiff of a century ago would feel right at home with the investment bankers' current emphasis on corporate restructurings, the lending of money to facilitate reorganizations and mergers, and even the acquisition of controlling ownership interests in major U.S. and off-shore companies.

To understand better these investment banks in the operating environment of the 1990s, it is helpful to dissect and examine separately the factors most critical to their operations. These include the people employed, the products and services being offered, the capital invested in the business, the geographic coverage of the firms and the firms' internal organizational structure. I will conclude with a few thoughts on the approximate governmental response to these developments.

People. The staffs of these wholesale investment banks have, like Topsy, "just growed"! Morgan Stanley, for instance, had about 250 employees at the beginning of the 1970s and today employs more than six thousand all over the world. And what a difference can be noted in backgrounds and qualifications of Wall Street professionals then and now. One now-retired investment banker related that, aside from the fact that he was a product of one of the leading Ivy League colleges, he was convinced that what had swung the decision to hire him just after World War II at one of the leading wholesale houses was the reassurance the interviewer felt on observing that the candidate was wearing garters to ensure that his socks didn't sag!

A perusal of the list of managing directors (they used to be called "partners") of any of the leading firms will confirm that today family, ethnic or nationality factors take a back seat to shear competence. The leading investment banks have for years been skimming the cream of the talent from the major graduate business schools and, despite the media image of an industry in full retreat, these firms continue to mount aggressive recruiting programs at the entry level in 1990.

The reasoning behind this is quite straight-forward: the major resource which these investment banks have to sell is human talent. To stay at the leading edge of the marketplace and to exploit change profitably, the firms must continually renew these people resources. Thus, even as many of these firms are announcing layoffs in the middle and upper professional levels, they are simultaneously bringing in a steady stream of new hires at the entry level. In fact, some firms' managers will admit privately that they are using the current shakeout in the industry as a cover for weeding out deadwood and upgrading their people resources. The day that we hear that these firms are sharply curtailing their entry-level recruiting effort will be cause for alarm bells to start sounding!

It is quite true that the myriad of recent problems on Wall Street have turned off a number of young professionals who might otherwise have had an interest in a career in investment banking. But there remains a core of young people with a serious interest in the kind of work that is done on the Street. After all, where else can a 29-year-old work day-in and day-out with the top managements of Fortune 500 companies on key financing or restructuring proposals?

The professionals' commitments to the firms which hire them and their activities and compensation over time have certainly been altered, however. They are now being offered high initial starting salaries and bonuses to entice them aboard. Compensation continues to rise from there. A young professional with five years of successful experience in the corporate finance end of the business could easily be making $300-400,000 in annual salary and bonuses. That would have shocked our Rip Van Winkle investment banker from the 1950s and 1960s, when associates (those that had not yet made partner) earned relatively modest compensation until they reached the pot of gold at the end of the rainbow: i.e., a partnership position. Today, with so many more employees in relation to a reasonably-sized group of managing directors, these aspirants know that the odds of ever making partner are much more pessimistic and therefore they have successfully pushed for higher near-term compensation.

And whereas it used to be that, like joining a college fraternity, once you had "pledged", it was assumed that you would stay with that organization for life, no such assumption is warranted today. Many employees (even managing directors) of these investment banks view themselves more like "free agents" in Big League baseball. Many of them have little compunction about shifting from firm to firm as opportunity presents itself. That, too, has escalated the pay scale.

Although the evidence is mostly anecdotal, it also appears that many of these fast-track professionals don't build personal net worths as quickly as the outside world may imagine. The cost of living as a professional family in New York is staggering. Investment bankers say (with a straight face) that a family with a couple of private school-age children is lucky to break even on a total compensation of $300-350,000! This makes it a little easier to understand the pressure for higher current income and the acute sensitivity to the level of current annual bonus payments. It does nothing, of course, to explain some of the compensation stories that have been in the newspapers in recent days!

Products. The firms have felt pushed headlong into aggressive expansion and hiring of people because of the explosion in new financial products and ideas in recent years. No doubt there are investment bankers who yearn for the good old days when they could count on banker-client relationships sustained over many years to assure that when a new financing was required, the corporate client would routinely steer that business to its traditional firm. That was why a firm's client list was such a valued and protected asset.

The value of that client list as a continuing source of business has been declining for some years, however. Some investment banks maintain that there are no real client lists anymore - every company's business is up for grabs at every juncture. That may be an overstatement. Several recent surveys confirm that most corporations still want at least one or two sources of reliable and ongoing counsel and service, even while they are happily receiving overtures from numerous other financial vendors with interesting new financings or other ideas to peddle. The company's traditional investment banker knows this, but continues to act as if he *does* have a stable of clients whose good will they must constantly cultivate. At the same time, the cost of pursuing the business of those clients with resources at least on a par with competitor vendors has sharply escalated.

One service and product that has defied the law of diminishing profitability on Wall Street is mergers and acquisitions. In fact, in looking at the profit-and-loss statements of several of the leading publicly-owned investment banks, it is now the tail wagging the dog of all the other businesses in which they are engaged. For several of the leading wholesale firms, revenues that flow either directly or indirectly from M&A activities is almost fifty percent of the total revenue pie.

Here, one must give the investment bankers a lot of credit for sniffing out a business opportunity with tremendous potential and then riding it for all it is worth. It is important to note that Wall Street didn't *create* the merger movement that has been such a dominant feature of the U.S. scene over the past fifteen years or so, but they did aid and abet it, enriching themselves in the process. As historian Alfred Chandler[2] has pointed out, the current merger movement, dating from about the mid-1970s, is the natural aftermath of the earlier "conglomerate" merger movement of the 1960s. Then, largely unrelated businesses (as distinct from "horizontal" or "vertical" integration of an existing business line) were strung together with financial rope; there was an exchange of stock or the issuance of massive amounts of debt securities by the buyer (in what were, in my opinion, essentially junk bond financings).

Because there was usually little if any real synergy resulting from the combinations, and distressingly little operating planning as to how these acquisitions were going to be managed so as to produce satisfactory profits to the acquiror, it shouldn't be surprising that these conglomerates started to come apart in the 1970s and 1980s from the force of economic "gravity". The investment bankers were predictably on hand as midwives, just as they had been on hand in the 1960s to glue them together in the first place.

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[2] Alfred Chandler, 1990. "The Enduring Logic of Industrial Success", Harvard Business Review, Vol. 68, p. 443.

In keeping with their reputation for spotting new trends and developments early on, the investment banks (and, most particularly the "wholesale" firms) saw these restructurings as a lucrative source of fees and so they began to gear up to meet the expected demand. None of the major wholesale houses had anything called a "merger and acquisition" group before 1975 (the firms' corporate finance professionals were mostly "generalists" who could turn their hand to underwritings, mergers, or private placements as the occasion demanded). But as the potential for this area became more evident, they geared up to the point where First Boston, for instance, had some 200 professionals permanently assigned to its M&A department by the mid-1980s. Risk arbitrage activities (speculating on stocks that might be imminently subject to takeover) and bridge (temporary) financing and junk bond activities became important collateral businesses.

And, as is well known, these kinds of spin-off activities got some of these securities firms into trouble. The risk arbitrage activity, speculating predominantly with the investment banks' own capital funds, was successful as a direct function of the ability to figure out before anyone else just which companies were likely to be put "in play" and what actions would follow once that had happened. While there was supposed to be a Chinese Wall between the M&A and the risk arbitrage activities, in some cases that wall was wrongfully pierced and information leaked.

The financing of these mergers and acquisitions was also a big business. The introduction of the "junk" bond (that is, one that had a relatively low credit rating) by Michael Milken and his firm of Drexel Burnham in the 1970s was the grease that made the M&A wheels turn. As already noted, lower-quality bonds had been issued in abundance in the 1960s but usually in a cashless exchange offer of one security for another between an acquiring company and the selling stockholders of the target company. Milken's new wrinkle was to find a group of investors (corporations, insurance companies, savings & loans, mutual funds) that were willing to buy these bonds *for cash*. The issuing company would then have a war chest with which to pursue acquisitions and pay for them in cash, rather than in securities that were often pejoratively referred to as "funny money".

When the rest of the Street saw in the late 1970s how much new business upstart Drexel Burnham was creating with this modus operandi, they, too, jumped into the issuance of junk bonds as a means of facilitating their own clients' M&A deals. Some got burned early on (Morgan Stanley issued tens of millions of junk bonds for client Peoples Express just six months before the airline went bankrupt at the end of 1986) but, overall, an extraordinary amount of financing was undertaken with this new vehicle. In the process, a number of multi-billion dollar companies were exposed to the threat of takeover for the first time (they had been too large to raid prior to the advent of junk bonds). Spectators like Carl Icahn, whose own resources were relatively limited, could now command billions in junk bond financing. LBO firms like Kohlberg, Kravis and Roberts (KKR) could also tap into this motherlode of new public financing and then successfully bid for the likes of Beatrice Foods (more than $6 billion) and RJR-Nabisco (about $24 billion). And the commissions on these huge deals were very fat for the investment banks.

It was only an additional step for the investment banks to put up their own capital as "bridge" loans to clients so that an acquisition could be completed in anticipation of a long-term funding by junk bonds or else a private placement, arranged by that same investment bank. These loans were originally undertaken as a counter to Drexel Burnham's "highly confident" letter assuring its ability to undertake new junk bond financing. As such, they were a means of completing deals and thereby earning the fees traditionally paid to investment bankers for acting as midwives to the combination or restructuring. The bankers soon discovered, however, that the fees for providing the financing were even larger than those for acting as M&A counselor. In one of the earliest such deals, First Boston earned about $12 million for representing Campeau in the 1987 purchase of Allied Department Stores but got some $30 million for providing Campeau with a $865 million bridge loan! Once they had gotten a taste of these fees, it became compelling to continue with this new and lucrative financing activity. The final step was to put the firms' capital into major (often controlling) portions in the equity of private sector companies. This has proved to be extraordinarily lucrative for the investment banks over the past decade.

But of course you don't usually get something for nothing, and the M&A bonanza has been no exception for the U.S. investment banks. Their increasing preoccupation with managing their own capital investments in marketable securities as well as in major equity positions in private sector corporations has raised conflict-of-interest questions that have driven a wedge of wariness and suspicion between themselves and their traditional corporate clients and institutional investor customers.

And that preoccupation with profitably investing their own capital has sometimes tripped up the best of the wholesale investment banks. First Boston, Salomon Brothers and other investment banks got stuck with bridge loans when they found they couldn't "fund out" these temporary financings with longer-term, publicly issued junk bonds. The firms had mobilized their capital as a competitive weapon, and it turned out to be a double-edged sword.

Capital. The investment banks' huge capital base is another very recent phenomenon which would have amazed Wall Street leaders of yesteryear. Back when the wholesale investment banks were mainly underwriters, they didn't need much capital. Issues were routinely "pre-sold" to investors by soliciting "indications of interest" before the issue was priced and thus there was usually minimal risk to the investment banking underwriters. Back at the beginning of the 1970s, Morgan Stanley had $10 million in capital on its books. By the beginning of 1990 this had grown to $2.65 billion. The other major firms showed similar growth in their capital.

The huge increases in capital bases were precipitated by the firms' branching out into all sorts of new products, as discussed earlier. Although firms like Goldman and Salomon had long been secondary market traders (that is, they regularly bought and sold stocks and bonds in the secondary markets), other firms, new to trading, steadily increased the pace and volume of their institutional trading services, therefore necessitating a larger and larger ongoing inventory of securities and the capital to finance it. In addition, the proliferation of hybrid securities products (eg., a floating-rate preferred) required their own accompanying inventory positions, further swelling the need for more capital.

The move into "bridge" loans to M&A clients obviously exacerbated the capital need still further and, at the same time, was indicative of the changing composition of these firms' balance sheets. The securities firms' mix of assets was becoming more risky because items like bridge loans were essentially illiquid and uncertain as to repayment. The large inventories of publicly traded securities of various types was also a burden, since with more volatile markets, there was always the prospect of large losses in the event of a sudden market turn in the wrong direction. This was thought to be the straw that broke the camel's back for E.F. Hutton at the time of the market crash in October 1987. The sharp decline in the value of its inventory of securities so eroded its equity capital base that lenders shut off further credit and thus helped force it into a shotgun marriage with Shearson Lehman. Similar mistakes and miscalculations tripped up Goldman Sachs in the spring of 1986 (precipitating the entrance of Sumitomo Bank as a minority investor) and Merrill Lynch in the fall of the same year.

With this increased emphasis on the amount and stability of a firm's capital base, the leadership of these investment banks has understandably been at pains to estimate and then lock in the required risk funds for the firms' use. This has been accomplished both by retaining annual profits in the business and by raising new equity from outside investors. One of the first moves made on the capital question was to incorporate the firms, shifting from a partnership form of organization to a corporate form. This not only limited the risk to the employees who invested their money in the firm, but also provided for continuity in the supply of capital. Retiring partners could no longer pull their money out at will.

A good bit of the growth in the equity bases was accomplished by the retention of annual profits in the business. As the firms grew larger, their total profits grew apace. And the most successful of these investment banks were earning in excess of 25% on their equity capital each year. This profit momentum is a powerful force for building retained earnings over time.

A second way that these firms grew their capital was by "going public" with offerings of their equity securities. With the exception of First Boston, which had long been publicly traded, no securities firm of any size was publicly owned until Donaldson, Lufkin & Jenrette successfully defied in 1969 the New York Stock Exchange's rule against member firms being publicly owned. That precipitated a number of public offerings of securities firms, although they were mostly firms that specialized in retail brokerage operations, not wholesale investment banking. There was a recurring suspicion that an important motivation for going public was that the insiders had lost their confidence in the profitability of the brokerage industry and wanted to "bail out." But, whatever the motive, "going public" did secure their equity capital bases against sudden partner withdrawals and made planning ahead easier.

A second wave of public offerings took place in the mid-1980s, when wholesale firms like Morgan Stanley and Shearson Lehman went public. In addition to raising large amounts of additional risk capital for the issuing firms, it also was a bonanza for the firms' partners. In the case of Morgan Stanley, the equity offering price was set at approximately two and a half times the firms' "book" value (i.e., the price at which those leaving the firm could normally withdraw their money). Thus, a departing partner who ordinarily would have been able to withdraw a book value of, say, $10 million from the firm (over a staggered period), would now have $25 million of market value for his/her securities (although there were restrictions as to when he/she could sell it!).

Salomon Brothers also went public in 1981 through a "back door" route. It merged with publicly-traded Philipp Brothers, a commodity trading firm. The price paid (in an exchange of shares) was more than twice the book value of the investment bank's equity at that point.

It is hard to fault the firms which have gone public for wanting to buttress and lock in their capital bases, particularly as the demands for capital have accelerated. And to arguments that the current generation of partners has, in the process, personally cashed in on the legacy of a number of previous generations' building efforts, it can be noted that much of the value creation in these firms has been a fairly recent phenomenon.

On the other hand, it is not clear that public ownership is the ideal financing mode for this particular type of financial service business. Managements of these publicly-owned investment banks must, of necessity, be preoccupied with how their actions will appear to a group of outside investors, many of whom lack the background to understand the longer-term rationale for moves which may have the effect of penalizing immediate results.

There is also the new worry over possible threats to control. When a large foreign investor in Salomon Brothers decided to put its block of stock on the market, Ronald Perelman, a takeover entrepreneur who had successfully acquired such companies as Revlon and Pantry Pride in contested bids, evidenced an interest in buying the block and presumably taking an active role in the oversight of Salomon. Another problem, that these firms' major assets - their people - take the elevator home every night and might decide not to return the next day if there was a disagreeable change in control. Perelman looked like a real threat to CEO John Gutfreund, who negotiated a deal with investor Warren Buffett and then took a number of actions which had the near-term effect of buttressing the firm's reported profitability. It wasn't (and isn't) clear that these were strategically shrewd moves for the longer term. This looks like a case of getting caught up in the "American disease" of preoccupation with reported results!

But with publicly-owned firms, you have to be a little sympathetic with the managers who are, after all, only responding to the markets. With the current preoccupation with return on equity capital (ROE) among the investment banks, some observers are even suggesting that some of these securities firms have *too much* capital. Certainly, if you squeezed down their equity bases still further, you could deliver an even more impressive return on the remaining equity, assuming that the basic businesses were booming. But the obverse of that is that the equity is supposed to protect the firm during downturns. If it is too thin, then it can't absorb the shock of normal cyclical reversals, as Hutton discovered and as Drexel more recently discovered. And the equity bases of the U.S. firms are already much thinner than those of many of their foreign competitors, particularly the Japanese. Whereas the average U.S. investment bank has about a 6% equity base, the Japanese firms have about 16%, and their assets are generally considered to be less risky than those of the U.S. firms. One has to wonder at the relative flexibility which each of these groups of firms will have in different sets of future operating and market conditions.

Despite these rather lengthy observations about capital, it seems to me that there has been too much emphasis put on the power of capital in discussions about the relative strengths of different investment banks. As has already been pointed out, the most important asset these firms possess is their human capital. If you have the best people resources, capital will seek you out. Thus, the imperative of going public to obtain sufficient capital to undertake an array of relatively capital-intensive businesses seems overstated. Capital follows people. If you have an imaginative and profitable use for capital on Wall Street, the necessary funds will be available.

Geographic Representation. Back in the more sedate days of the 1950s and 1960s, U.S. investment banks did only a modest amount of foreign business, mainly sovereign debt financings for European countries. Kuhn Loeb (now part of Shearson Lehman Hutton), White Weld (now a part of Merrill Lynch) as well as Morgan Stanley were among the most active in this offshore market. Foreign corporations were accelerating their use of the New York capital market when President Kennedy imposed the Interest Equalization Tax in 1963, making it much less attractive to borrow in the U.S. for use abroad. By choking off the supply of money from the U.S., this action helped boost the fortunes of the nascent Eurodollar market, which was destined to grow dramatically in the next two decades until it rivaled in size the U.S. corporate bond underwriting markets by the late 1980s.

It was inevitable that as the U.S. switched from a position of a major capital generator to being the largest capital absorber, the U.S. financial vendors - and especially the U.S. investment banks - would want to get closer to these offshore sources of capital. They offered the foreigners a variety of financial products which helped push the capital account into surplus to offset the worsening U.S. trade balance. Further, the increasing economic interdependency of the industrialized world was steadily raising the level of cross-border transactions. This ultimately meant that financial service vendors of many types - the investment banks prominently among them - would require a presence in a variety of geographic locations.

Some of the more aggressive U.S. investment banks recognized this trend early on and went to Europe in the early days of the Euromarket. The prospects for capital market activity in Asia became more evident in the 1970s, and a number of firms subsequently set up operations in Hong Kong, Singapore and, most important, Tokyo. Those with the longest tenures in Tokyo obtained the first licenses to broaden their permitted scope of activities. Despite significant regulatory and cultural barriers to entry into the host country's domestic markets, the volume of business conducted out of these foreign outposts grew dramatically over the years. It became an important competitive asset to have strong representation in these important foreign markets - particularly London and Tokyo. Furthermore, because there continue to be significant barriers that impede the free flow of business among the various geographic market centers, it also became a competitive advantage to have offices established in other country market centers, such as Frankfurt and Zurich.

In essence, the markets for capital have for all practical purposes become global, as far as investors and capital raisers are concerned. The major securities intermediaries are moving in that direction, too, but they have quite a way to go. The historical barriers to entry into the various domestic markets are tenacious, particularly when they are based on culture and business practices rather than formal regulatory impediments.

Not surprisingly, the resources committed by the leading U.S. investment banks to this geographic coverage have been impressive. With 400 to 600 employees in each of the London and the Tokyo market centers, some of the dominant investment banks have more people based in each of these market centers than constituted their total employee groups in the early 1970s. And the cost of maintaining that presence can be staggering. After activity in the Euromarkets fell off in 1987, both Salomon Brothers and Shearson were prominently among the U.S. securities firms that laid off staff in an effort to rein in the overhead costs. Significantly, Tokyo was not part of the staff-trimming. There, the business momentum has continued upward. It is difficult to get an accurate sense of how much money the U.S. investment banking firms in Tokyo are making, but it is believed to be a significant source of current profits and a promising area for higher profits in the future.

Firms' Organizational Structure. One of the challenges which the U.S. investment banking firms have had in accommodating this high growth over the past two decades - and particularly the off-shore part - is maintaining the internal organizational structure which best balances the various factors needed to operate successfully in this business.

A study of internal organizational structures of investment banks by Eccles and Crane[3] indicates the need for a relatively free-form structure which gives maximum scope to the natural entrepreneurship of the people employed there as well as the opportunity for stitching together ad hoc internal working groups needed to expeditiously and effectively do the business. In the 1950s and 1960s, the small staffs of professionals all housed at one location made this relatively easy to accomplish. Constant visual oversight and personal, day-to-day interaction helped accomplished that purpose.

Heading into the 1990s, the internal operating circumstances are much different. A myriad of product lines employing several thousand professionals and several thousand additional support staff in multiple locations all over the world presents a much more daunting management and control challenge.

Given these forces, it is a miracle that the firms have been as successful in their complex management task as they have been. Their preservation of market positions and the enormous expansion in their revenue and profit figures attest to that. Nevertheless, a number have stumbled along the way. Two of the most important difficulties have been burgeoning overhead and employee misbehavior.

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[3] R.R. Eccles and D.B. Crane, 1988. Doing Deals, (Harvard Business School Press: Boston).

As already mentioned, the headlong growth in the volume of available business created enormous pressures to grow the firms' resources to meet that demand (Salomon Brothers grew its personnel by 40% in 1986, for instance). Inevitably, efficiency was sacrificed. Industry statistics show that during this high growth period, revenue per employee declined. But, with the volume of business constantly rising, this still translated into growing bottom-line profits for a number of the leading wholesale firms.

When downturns inevitably appeared in product and market areas covered by these firms (beginning in 1986 for trading and in 1987 for Euromarket and U.S. brokerage), the dilemma was how to bring the overhead costs into line with reduced revenues without destroying employee morale and gutting the firm's long-term presence in these market segments. Since a large part of the overhead was people costs, they could theoretically be trimmed back fairly readily. Yet, the firms' managements were loathe to lay people off and thereby damage internal morale, as well as the image of invincibility that was being projected to the outside world. They did make substantial employee cuts in the end, aided by the general malaise which hit the whole securities industry and which therefore provided some "cover" for the cut-backs initiated by individual firms.

It is the area of oversight and control of employees' activities which has perhaps been the most vexing for the securities firms and the most damaging to the industry's standing in the eyes of the U.S. public. As the volume of M&A-related business accelerated, and as more and more people got involved in more and more loosely-related parts of this business, evidence came to light suggesting that some employees had illegally used confidential information either to enrich themselves directly or to improve their standing within their firms.

These revelations came in the wake of the considerable (and much-publicized) disruption to a number of local communities which the whole restructuring movement had wrought. It also came in the aftermath of news reports of enormous capital gains earned by some Wall Street insiders on corporate restructurings, along with media stories about the huge compensation packages paid to Wall Street deal-makers. Former Secretary of the Treasury William Simon's reported $75 million profit on the sale of Gibson Greeting Cards within 18 months of its purchase from RCA for barely $1 million in equity was one vivid example that stuck in peoples' minds. Another was the revelation that Drexel Burnham Lambert paid Junk bond and M&A impresario Michael Milken some $550 million in compensation in 1987 alone.

The allegations of illegal use of insider information beginning in 1985 thus created a sensation when reported in the public press. The fact that it encompassed at least several of the leading investment banks cast a further pall on the Street's national image. The deep populist roots in the U.S. were much offended by these accounts and there was strong pressure on Congress to "do something" in response. I have already mentioned that there are compelling arguments, despite these vendors' excesses, to support the position that Wall Street was acting as a facilitator, not an instigator, of the recent M&A restructuring movement. Nonetheless, the spate of Congressional bills being introduced and hearings such as this one are evidence that the U.S. securities industry is paying a price for this public disaffection.

Government Response. Over the past two decades, the U.S. has led the way in reducing regulatory impediments to the efficient fuctioning of the U.S. financial markets, and the rest of the world has followed in our wake. The public securities vendors in the U.S. are the acknowledged world-class competitive leaders which everyone else seeks to emulate. In my view, it would be a mistake to attempt to re-impose a whole skein of new regulatory limitations in reaction to the evidences of abuse by some participants in our financial markets. In this increasingly inter-dependent global financial grid, restrictions imposed by one country (even one as powerful as the U.S.) would be likely to drive business off-shore and possibily out of the hands of our own vendors into those of other countries in the international financial marketplace.

At the same time, it is also a practical matter that in a country with the deep populist roots of the U.S., there must be adequate safeguards which insure that the markets give a fair shake to all investors. I have already noted that the public's perception of Wall Street activities has, rightly or wrongly, created a reservoir of ill will towards the Street. Congress can best serve this country's long-term position in the international financial service sector by insuring that abuses are dealt with promptly and appropriately. The "theft" of insider information is one such area. Another is the encouragement of full disclosure of information so that all investors have the same potential access to information in advance of making a purchase or sale of a security.

These issues stand in sharp contrast to such relics as the Glass Steagall Act. Whatever its merits at the time of its original passage in the 1930s, it is incongruent with the realities of the 1990s and should be formally repealed. The fact that effective securities industry lobbying has thus far prevented its replacement is more an indictment of our legislative process rather than a reflection of valid concerns about the consequences of repeal.

And this brings me to the question of the organization of regulatory oversight. Historically, we have made a virtue out of our fragmented financial market regulatory structure, invoking the populist fear of overbearing central control. But the consequences of this dispersion do not serve us well as we face the intensified international competition of the 1990s. As a country, we need to be pro-active in the formulation of long-range financial market policies. Instead, we have been largely re-active. We don't always speak with one voice in negotiations with representatives of other important financial market centers. We become stymied in efforts to effect change on other than a piece-meal basis. Historical experience suggests that such a stance rarely yields the sort of comprehensive policy guidelines which will most effectively serve the country's long-term interests.

Mr. Chairman and members of the subcommittee, that completes my prepared remarks. I appreciate your attention and thank you for inviting me.

Senator Dodd. We thank you, Mr. Lipper, for being with us.

STATEMENT OF MICHAEL LIPPER, PRESIDENT, LIPPER ANALYTICAL SERVICES, INC., NEW YORK

Mr. Lipper. It's difficult to add anything to four of the industry leaders and the leading professor who follows the industry. So I will be quite brief. You have my written testimony. It's an honor to be here today to discuss the industry with you.

A couple of points I will make and only a couple.

First, the industry has recorded record revenues and the margin squeeze is largely a compensation issue.

Second, what we have heard this morning largely is about the large firms. Professor Hayes talked of six. The SIA data talks of 12. Beyond that there are many other firms. The difference that I think is critical is that the large firms are very different than the small firms. They not only serve different functions, they also have a very different financial makeup.

We've heard a lot about the institutionalization of the market almost with the idea that institutions are bad and that the individuals are being disenfranchised. Please remember that the largest growing parts of the institutional market are, first, the pension funds which clearly represent the individuals, second, that the mutual funds, which also represent the individuals and, third, the trust departments of banks, which also represent individuals. So the individual is represented. The difference is the individual, either by choice or by fiat, is having a professional make the decisions.

We have heard a lot about various regulatory changes, some of which were the purview of this committee in the past and some were the purview of other committees and other agencies. I think one of the points that I urge is that any new regulatory initiative consider all the unintended impacts. I think Mr. Gutfreund certainly alluded to that when he talked about the end of fixed rates.

Another point that I think is important to bear in mind is that our discussions almost seem to focus entirely on either the stock market or what I would say is a derivative of the stock market, which was the junk bond market. I think it's important to point out that the high quality bond market, including the treasury market, is many times the size of the equity market, and that's a critical element of why the industry does reasonably well.

On the bond market I think we can see something that has nothing to do with program trading, but I think shows the nervousness of individuals and institutions and perhaps correctly based on the history, and that is most of the money is invested in short-term or at least intermediate-terms bonds.

I think what has happened here is that there is a lack of confidence in the future of the value of money and perhaps of the value of various issuers. I'm not saying that they will go bankrupt, but what they will produce in the way of economic return to the bondholder as well as the shareholder is not worth taking the risk.

There has been some discussion about the decline in individual ownership of equity. One of the points that I think is important to remember is a good bit of this decline is, one, because of estates and, second, because of the buyouts. The long-term holders of RJR common have had no choice. They became investors in cash and for the most part that cash did not return to the stock market.

These are the points that I think are of value. I would also suggest that on the returns that people have gotten through mutual funds, the funds have produced an average return, general equity, of about 15.6 percent for this decade and certainly large returns over 30 years. These returns have been large enough to meet any of the actuarial needs of building an estate.

With those comments, I'm certainly open to try and answer your questions.

[The complete prepared statement of A. Michael Lipper follows:]

THE SECURITIES SUBCOMMITTEE OF THE U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Hearing: "The Conditions Of The Securities Industry"

Testimony: A. Michael Lipper, CFA, President
Lipper Analytical Securities Corporation

Date: March 6th, 1990

Good Morning:

I very much appreciate the opportunity to share my views with the Subcommittee as to the health of the brokerage community. To put my views into perspective, you should know that I am President of Lipper Analytical Securities Corporation which is the fourth New York Stock Exchange member firm that has been owned in my family. The other three, retired profitably when conditions appeared to be unfavorable for survival of their earned capital, based upon their type of business. We are a member of the New York Stock Exchange as a means to getting paid for the research produced by our affiliate Lipper Analytical Services, Inc. We analyze investment companies, securities firms and convertible securities. Our analysis covers both domestic and international activities. Our firms employ approximately sixty employees full-time and another twenty employees part-time or in consulting roles. We are extremely fortunate to have Perrin Long as our Senior Analyst following the brokerage industry. He has been referred to as the Dean of the Analysts following the brokerage industry. The regard for our ability to analyze the brokerage and fund industries is in part based on our independence. Thus, the views we will share with you are both grounded in a historic understanding of the "Street" and our need for independent, if not contrarian views.

In the way of an introduction, the brokerage industry is part of the investment system of our global economy. In the long run, the health of the industry is more dependent upon the other factors impacting the global investing system, than on matters internal to the brokerage industry. In short, the significant factors that control the industry's future include, the growth of global money supply. We have just concluded a decade wherein money supply has grown in most countries faster than the productive needs of the relevant economies. This excess supply of money found its way into the investment system. The excess led largely to investment performances around the world that far outpaced economic gains in the decade.

We believe that the current decade's progress will be a function of savings and risk assumption. We expect that throughout this decade we will see attempts to reduce expenses at the government, corporate and individual levels to reduce debt, develop contingency reserves and build investment capital. The key to the future success of the brokerage industry is to have the industry undertake less capital risk and to induce investors to take more risks in terms of duration of their fixed income holdings as well as selling more equities.

The strength of the brokerage industry rests on four pillars which need constant maintenance. The first are the people within the industry. The industry attracts highly motivated, competitive and reasonably intelligent people who are willing to work long hours. The vast majority of these individuals have a high level of integrity. The second pillar is large amount of press coverage of the industry. The press finds the activities of the industry newsworthy to an audience well beyond direct investors. The third pillar is what we are doing today, which is the worldwide interface between governmental leaders and the investment industry. In the absence of fixed exchange rates and fixed interest rates, the market mechanism is, between elections, the principle disciplinarian of the political-economic system of this country. The fourth, and central pillar is the long-term investment successes enjoyed by our clients in meeting their needs for estate building, education, and retirement capital. The industry relies on the interrelationship of confidence between these four pillars. The success of the industry is easily measured by the record level of revenues earned by its members, the record level of assets managed through various institutional investors and the ability of institutional and individual clients to meet their current needs.

The weaknesses of the industry do not come as major surprises, in view of the industry's tremendous growth in the last decade as well as a number of structural changes. Perhaps the biggest weakness of the industry stems from public ownership of its securities. This is an ironic view coming from us, considering the revenues we derive from following the industry. Significant public ownership of brokerage firms has two impacts; first there is a significant separation of ownership and the management. Second, public firms are more oriented to their income statements and private firms more to their balance sheets first. These impacts led public firm managements to take on more risks in search of rewards.

If one looks at those firms which are having financial difficulties today, they share to some degree in the following characteristics: First, most of their sales people and investment banking/corporate finance employees are relatively inexperienced, having only been in the business during the good times. They spent very little time learning the history of the business. One might say that in a business sense, many of these people were immature, but the events of 1987 through today, are likely to make them old before their time. Second, while revenues are record levels, operating earnings, that is earnings that are derived from agency activity, underwriting and trading activity are low or non-existent. The industry earnings are now largely from net interest generation. The problem facing many large firms is that they have had poor expense control, largely due to a short-term compensation orientation. This is particularly true of New York based firms, whose margins are likely to be under increasing pressure. Third, and perhaps the strangest of the problems facing the industry, is that it has too much capital. Excess capital is often applied in a fashion that promotes risks rather than reduces it. For example, bridge loans, proprietary trading, etc.

Most of the attention placed in your questions seems to focus on activities that come under the rubric of leveraged buyouts/merchant banking. These activities are concentrated in a small number of large firms. These large firms are not small firms that are more successful than others. The large firms are in many respects in different businesses than the other firms.

The academics tell us that the brokerage industry's value to society is as a capital allocator. I would agree with that view, but not because of the industry's judgement process, but by its' price discovery function of bringing buyers and sellers together. Thus, there is a continuing need for public participation in the markets. Despite the importance of the industry's function in an exceedingly complex economy, its pretax profit margins have been in a secular decline at least since 1972 when it earned 13.2% on total revenues of $5.99 billion. In 1976 and 1980 pretax margins hit their peak levels of 14.2%. By 1988 margins had slipped to 4.8%.

We estimate 1989 pretax margin at under 4% on about $59 billion in revenues. First quarter 1990 margins are likely to be still lower. This pretax profit margin decline has been mitigated by doubling the financial leverage in terms of the level of liabilities undertaken compared with assets. Most of the increase in leverage is by the large firms in connection with their fixed income activities.

Derivatives need much greater study on a continuing basis for appropriate regulation. I find derivatives, in general, to have little general social benefit. In 1928, agricultural options were outlawed due to excess speculation. Nevertheless, I believe before such steps could even be contemplated, one needs much greater study by all of the talents that were represented in the administration's "working group". This group should get a better understanding of the activities of the practitioners. The games being played appear to be much different than the theory. The need to continuously analyze, and perhaps regulate this area is particularly true of the largest of these speculative markets which has little or no regulation. I refer to the foreign exchange market.

With regard to the competitiveness of the U.S. industry, the principle negatives of the U.S. based industry are our high compensation base and our true lack of fluency in foreign languages. Our advantage is that we currently have the best market mechanism in the world - we just don't have enough of the best customers. In part, this is due to the long-term decline in the value of the dollar and also the policy of the U.S. government to seize foreign assets e.g. Iranian and Panamanian when there is no declared state of war.

In terms of a possible restructuring of the industry we think it's important to bear in mind the principle that professionals in most walks of life turn to other professionals to protect them when they are dealing with professionals. A lawyer who has himself as a client is often viewed as a fool. Thus, I think investors are better protected if there is a separation between agent and principal activities both in terms of trading and underwriting, than having them combined in a single delivery system for financial products. While I recognize that there is some cost efficiency in combining underwriting or buying or principle activities with selling activities, the cost of losing independent advice may be too great. There is a value in a second opinion as to fair price.

Regardless of whether the organized markets and financial systems work, the public will continue to invest through the market or locally through private investments. There is some question as to which would be better for society, but I would hope that professional investors could do a better job than pure local private investing.

While this morning's session is designed to be an informative hearing, we must suspect that in time there will be legislation. I hope that any legislation that is contemplated will be examined extremely carefully. Many of the problems that were discussed here today were the result of unintended impacts of past changes in legislation and regulation. For example, the decision to employ negotiated rates of brokerage commissions, the lifting of the regulation Q, the promulgation of Rule 415, the removing of the capital gains differential and the loosening of Rule 28(e).

On an overall basis I, think that the brokerage industry which has always been cyclical is undergoing one of its down phases in a cycle. I also believe that the market system around the world will correct many of the mistakes and abuses of the past. We live in an extremely dynamic world with our industry going through its own restructuring due to economic forces. My guess is that this decade will see a significantly slower growth in industry revenues, improved pretax profit margins and growth in net income. If not, I will probably follow the family tradition and retire profitably. Our upbeat prediction is predicated on no substantial regulatory change, as it is unlikely that changes in regulation will have the desired impact without unintended side effects. The way for our society to benefit from a sound investment community is to strengthen the four pillars I mentioned, and in doing so, to increase our confidence in our ability to provide for ourselves and others throughout the future.

Thank you.

Senator DODD. Thank you very much, Mr. Lipper.

You heard the first panel, the brief discussion toward the end raised by Senator Riegle, about Glass-Steagall and the responses, the interesting response of Mr. Gutfreund in light of Mr. Straus' recommendations and of course what has been offered in between.

I wonder if the both of you might comment on the impact of, the elimination of Glass-Steagall. What would be the implications, in our view, of such steps in terms of regional markets, and obviously an independent securities industry? I mean it isn't just a question of consolidation, but the survival of an independent industry.

Mr. LIPPER. Well, I think we always have to start with the consumer, and I think if the consumer is well served, then the industry has to restructure on the basis of that.

I think that to have the banks enter the business of providing investment service, they have to then be willing to undertake fiduciary responsibility and suitability responsibility just as brokers and advisers do. They have to develop a culture and an inspection system and frankly be willing to be sued as often as brokers are. And I think the results will be similar. They will be sued perhaps more often or perhaps less, that's immaterial, but I think that's the nature of it.

In terms of the independent brokerage activity, to some degree by bringing the banks in, that could be very positive because one of the problem facing the society right now is not enough people invest. If the banks come in and you somehow make it sound safer, you'll bring more people in.

It would be my guess that the banks will not be able to compensate their people or control their people as well as the independents, and in time all that will happen is that the banks will create a market share advantage for the independents, but that will take some time.

Senator DODD. Professor HAYES.

Mr. HAYES. Well, the kinds of market forces that Mr. Lipper is talking about I think are really the most important ones. Services and products are bought and sold based on the value that is received and the service that is given.

My own view, and it's in my written comments, is that the Glass-Steagall Act is an anachronism, that it's essentially hollowed out, it has been drilled through, it has been leaped over and oozed under, and that when we finally do formally repeal it, it will be a nonevent because of events that have taken place in the markets and offshore markets.

So I would certainly be in favor of a formal burial for Glass-Steagall with the proper safeguards that the first panel mentioned.

Senator DODD. There was some discussion here today at length as well about the split regulation between the equity and equity related markets, as well as the whole issue of margin requirements and so forth. I wonder if you both might comment on that discussion as well.

Mr. HAYES. Well, the whole question of appropriate regulatory oversight is a critical one, and the Brady Commission did deal with this in their report, as you know.

I have a feeling that we are suffering from too many cooks with their spoon in the broth, and particularly when we're trying to deal with an increasingly complex and interrelated marketplace both domestically and globally. We need some central coordination.

We have two very highly competent and professional organizations in the SEC and the Federal Reserve, and there needs to be a way found to harness the professionalism and the oversight of those two organizations in a collaborative effort.

In some ways we operate at a real disadvantage to, for instance, Japan where they have one Ministry, the Ministry of Finance, which has been in existence since 1878 and which has overseen and guided the whole financial market development for a century since then.

Senator DODD. Mr. Lipper.

Mr. Lipper. I hate to disagree with Professor Hayes, because that normally means that I'm wrong. But I would suggest that if we do have a unified voice, it could be the wrong voice.

I would also point out that there is a different philosophy in regulation. The SEC is in theory regulating for the benefit of the unwashed investor. The Federal Reserve in effect is regulating to keep the safe and soundness of the banking structure.

So one is for the customer and the other is for the provider. I'm not sure where the CFTC fits in that continuum, and I'm not sure how you solve that. Maybe what you have to do is to have both types of regulation and somehow through the Congress or through the administration reach periodic compromises. But I do think that there is a very serious issue as to who are you regulating and what for.

Senator DODD. But why should there be a contradiction. I mean I would think that if you're protecting the consumer and also regulating the provider, there is no reason why they shouldn't be consistent. My point is you're sort of implying there is an inconsistency in that.

Mr. LIPPER. In theory you are correct. I don't think it works that way in practice. I think if one just looks at the Federal Reserve and the SEC in terms of their disclosure requirements for the users of those services, they are a great deal different.

Senator DODD. What are you recommending, Mr. Lipper?

Mr. LIPPER. That there is a natural controversy between the supplier and the user, but I think we have to recognize that and somehow coordinate those natural tensions, and I'm not sure how to do it, sir.

Senator DODD. Rather than providing a single regulator?

Mr. LIPPER. Yes.

Senator DODD. All right. Professor Hayes, at the outset of your testimony you talked about the importance of understanding the vendor in a global market, and we had a tendency to talk about the New York capital markets here. In your view, is there a role for the regional market?

Mr. HAYES. A regional market being a national market, Senator?

Senator DODD. Within the country here. We had Mr. Simons from what we would call a regional firm, and there are those who suggest with the burial of Glass-Steagall and others that we may be going back to the point we made earlier about the family farm. Is there a role for a regional firm?

Mr. **Hayes**. Yes, I think there is. In some recent researcher a colleague and I reached the conclusion that there are still very distinct national securities markets where there are large barriers to entry for foreign firms.

I think the first panel made the point that Japanese firms in the United States haven't done all that well, and in fact we've done not all that well in Tokyo, although——

Senator **Dodd**. For different reasons I presume.

Mr. **Hayes**. Excuse me?

Senator **Dodd**. For different reasons.

Mr. **Hayes**. Yes, for different reasons. Some of them are regulatory, but most of them are business and cultural barriers to penetrating these national markets. So I think that for the foreseeable future we can expect that there will be a number of national securities markets that will be important and that some vendors can successfully confine themselves to just that one marketplace. So I do see a role for the regional or national firm that decides not to become international in scope.

Senator **Dodd**. I see. Thank you.

Do you agree with that, Mr. Lipper?

Mr. **Lipper**. Yes, I do. The firms that have the highest price-earnings ratios, highest price to book value currently, happen to be retail firms with the exception of Morgan Stanley. Most of their business is coming out of smaller towns and most of it is coming out of individuals.

I tend to think that the market depends on individual confidence, and individual confidence tends to work better by knowing the people who own the shop or at least represent themselves as those who own the shop.

Senator **Dodd**. That's a good point.

I used earlier, Professor Hayes, your statistics on the percentage of a 6-percent equity base versus a 16-percent equity base. I also was curious about Mr. Parcell's comments that equity financing will be the wave of the future once again. I wonder if you might shed some light on that?

Mr. **Hayes**. Well, I think you're actually raising two questions. My 16 percent and 6 percent statistics referred to the relative amounts of equity capital utilized by Japanese and United States securities firms, respectively. Of the funds they have invested is such things as securities, bridge loans, and other assets. Six percent of that is financed by their own equity and 94 percent is financed by other people's money, which means that they have a very thin margin for error. Whereas in the case of the Japanese Big Four securities firms, their average equity is 16 percent of their assets, and therefore only 84 percent is financed by other people's money. I think that gives them greater strength and greater resiliency than our firms.

But as far as equity versus debt is concerned in the 1990's, I think that we're bound to see more equity issued in the 1990's for several reasons. One is that corporate America is now more highly leveraged and will in some instances be looking for ways to reduce that risk. Second, it is likely that successful leverage buyouts will be seeking to "so public" with new equity offerings.

Senator **Dodd**. Safeway I think.

Mr. **Hayes**. Well, that would be one example. Tiffany and Company did this a couple of years ago, too.

Senator **Dodd**. Mr. Lipper.

Mr. **Lipper**. I look at it from the investor's standpoint, and over any extended period of time equity has produced a higher return to the investor than debt. I think as our demographics change as we're moving more into by force the population bubble, into people who are now very concerned or are starting to be concerned about building a capital base, that will become more equity oriented.

The biggest risk facing almost every American is that they will outlive their capital. The only way to grow capital at a fast enough rate so that you can live on it is equity, and I think that message will be getting across.

I think the 401K plans and the IRA's that would be expanded are starting to get people to believe. I think one of the things that we are seeing is private company equity is increasing. I think most private companies' balance sheets are very heavily equity oriented, and I think they will later on in this decade be the source of a good bit of growth.

Senator **Dodd**. Let me play the professor here, Professor Hayes. If this were the end of the class, I suppose the professor might say let's summarize. We started out the hearing talking about the condition of the securities market and there are some problems. I think there is a general uniformity of thought here.

What would you suggest would be the three, four or five things that we need to be doing in the public sector, on this side of the dias, and that the industry needs to be doing on their side of the table as we move into the 1990's to make this industry stronger and more competitive in light of what we presently face here at home and abroad?

Mr. **Hayes**. Starting with the industry and then moving to the Government, I think that the firms have to get their houses in order, and they are in the process of doing that. It's been painful and it has been disruptive, but they really have to rationalize their operations and they have to make some hard choices about what they are going to do in the a global marketplace in the next decade or two.

I think another thing that they should do is to ensure that they have enough risk capital. I hear some security analysts talking about these firms being overcapitalized. I don't agree. I think that we need a particularly strong capital base to have the staying power when they can come up against the large universal banks in Europe, which Mr. Gutfreund was talking about, and the Japanese securities firms and Japanese commercial banks.

From the point of view of public policy, I have indicated that I don't think that our experience with regulations suggests that a major new regulatory initiative in the legislative area is a good idea. But we do need to ensure that we have the support of the country for our financial markets as we move forward into the 1990's. I think that is a problem right now.

We must insure against the abuse of confidential information. Then there is the question of full disclosure of information. One of the members in the first panel suggested ours is the best in the world. This is true, but it's eroding. More and more of the financing in the United States is being done either in private arrangements or else through shelf registrations, which don't allow for full disclosure.

Finally, as I have indicated, we can play diverse regulatory mechanism, which was really designed that way, to keep control dispersed because we didn't want any one entity to have too much power. This served us well during the days when we were an isolated country and, later, the dominant world power. We were the Galapagos Islands. We could do anything we wanted. We were the 500 pound gorilla, and if we decided to have our central bank separated from our securities operation and separated from our futures regulation and separated from our savings and loan oversight, fine, we got away with it. But not any more.

We are still the first among equals, but the rest of the world is catching up to us, and our regulatory arrangements help determine our success in negotiating with other countries in an effective way.

Thank you.

Senator DODD. Very good.

Mr. Lipper, do you want to comment?

Mr. LIPPER. In general I agree with Professor Hayes with one exception, that his focus is the strength of the United States industry has to be big in order to compete with the universal banks and the large Japanese city banks as well as their brokers. As long as we cannot develop a retail system in their countries, I do not believe we will ever have the quantity of assets, to compete.

However, I do believe that we should have a quality of skills and, as a matter of fact, I suspect that we have superior skills and superior ability to manage risk than they do. As he pointed out, the Japanese took control of the Eurodollar market by buying it very expensively. I do not believe that they will show great profits there.

The view about the industry having too much capital is ours because we are concerned that capital has been misused to assume risk rather than to reduce risk.

In terms of public policy, I think the value that you are doing right now is the greatest value, which is turning the spotlight on the industry and industries and asking critical questions. I think many of the changes that we saw in the leverage buyout junk bond era came from hearings rather than legislation. So I would urge you to continue hearings on a periodic basis.

I agree with Professor Hayes that I do not perceive a legislative initiative that has a chance of solving more problems than it would create.

Senator DODD. Very good. We thank you both for that, and I'm confident some of my colleagues may have additional questions for you. You have been very helpful this morning.

I appreciate your last comment. I've often said I feel the biggest job we can do as legislators is become educators in a sense. If you can inform people of a particular situation, I find solutions begin to percolate up, whether they come from the public sector or are initiatives that emerge out of the industry itself. So I agree with your assessment that just turning the lights on sometimes can help tremendously in these areas.

It has been very helpful to have both of you here today, and we look forward to an ongoing dialog with you as we explore this issue further and deal with the variety of issues before the Congress that will affect the industry.

As I said at the outset, this industry is terribly important to the economic well-being of this country, and particularly as we enter this last decade of this century and move into the next with all the changes that are occurring in the world and the emergence of the new wealth and new labor pools and new challenges.

I think it's going to be vitally important that we focus our attention on what needs to be done to make sure that the engine of capitalism in this country not be lost. Decisions that may seem innocuous today could have a profound effect on the ability of this industry to succeed and survive as we move through this decade.

I'm painfully aware of how important a role we can play in the Congress either committing sins of omission or commission. We've been guilty of both in the past and we've got to avoid that. The best way I know how is to at least educate ourselves and to listen to people like yourselves as we go about the business of making those public policy choices.

Senator DODD. So, again, I thank you for being here today, and I express the gratitude of my colleagues as well.

This subcommittee will stand adjourned until further call of the Chair.

[The subcommittee adjourned at 1:30 p.m., subject to the call of the Chair.]

[Response to written questions for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM

Michael Lipper

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March 27, 1990

Ms. Lory Breneman
Chief Clerk
Securities Subcommittee
Committee on Banking, Housing and Urban Affairs
Dirksen Senate Office Bldg., Room 534
United States Senate
Washington, D.C. 20510-6075

Re: Senator Terry Sanford's Questions of March 6, 1990

Dear Ms. Breneman:

Q.1. Will S.2160 help address the problem of churning? Is 30% of income from shares held for less than three months the right place to draw the line? Is using tax incentives a better way to address the problem?

A.1 There are others who are more expert at dealing with pension funds than I and thus their views should carry more weight. The reference in your question to the "Short-Short" rule that currently applies to mutual funds is an area which we continually analyze and thus can report the following: For equity mutual funds with fiscal years encompassing some part of 1988, the average turnover rate was 95%. The median was 65%. The dollar weighted average 77%. These figures are based on a universe of 1,092 mutual funds.

The mutual fund industry and its principal trade association the Investment Company Institute, has for many years looked to remove the "Short-Short" rule. The claim of the industry is that it prevents managers from time to time managing the fund in the best interests of the shareholder. There were a number of cases, particularly of new funds in 1987, that the manager had the choice of violating the "Short-Short" rule and thus becoming a taxable entity or preserving assets in a declining market for the shareholder. The general view in the industry is that the "Short-Short" rule is an artificial constraint. The mutual fund industry does have a number of funds with extremely high turnover rates in excess of over 500% and in a few cases over 900%. Thus, the constraint apparently does not stop all active traders. Therefore, if a pension fund portfolio manager chose to transact in a period less than three months I believe that he should be able to do that for the beneficiaries of the plan. There are two types of plans: defined benefit and defined payment. In defined benefit plans, the sponsor is obligated to payout the defined benefit. The sponsor therefore is at risk. In the defined payment, the sponsor is obligated to make a defined payment and the beneficiaries receive the results the payments have generated. Defined payment plans are growing and may in time be the predominate type of plan, thus any tax on the plan would fall on the beneficiaries. The fastest growing part of the pension businesses are the plans of sponsors who do not pay income tax - state and municipal pension funds and tax exempt organizations, schools, universities, hospitals, etc. A tax on these plans raises many legal issues.

Q.2. Is it possible to obtain "independent" appraisal of the fairness of a leveraged buyout offer? Is this approach likely to help disclose more of the facts surrounding LBOs so that the conflicts management faces are less?

A.2. As we produce only a limited number of fairness opinions, and only on management companies and brokerage firms, we may not be the best place to seek this answer. A fairness opinion is designed to deliver an independent view as to the financial fairness of a transaction. As most LBOs were done at prices that were considerably higher than before the transaction was initiated (and in many cases the LBO transaction was for cash or at least with a cash alternative at the time of the deal) we would think that most investors that owned stock in these companies did receive a fair or if anything perhaps a too high a price.

There is perhaps another area where some protection might be needed and that is whether the deal is fair to the debtholders. Debtholders could also include the local tax authorities.

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Ms. Lory Breneman
March 27, 1990
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Q.3. Do you agree with Mr. Kohlberg's views that excesses with respect to fees and conflicts of interest occurred during the 1980's? If so, despite the downturn in the junk bond market, is there anything to prevent those excesses from occurring in the future?

A.3. I believe that Mr. Kohlberg views are in part correct. However, the largest contributor to the growth in fixed income investing in the 1980's was the excessive growth of money supply which left the banking system and individuals awash with cash.

I would be reluctant to see any regulation of fees undertaken. As a believer in the free market economy, if knowledgeable buyers and sellers of services wish to pay a fee to get the job done they will find a way to do this.

The excess in the junk bond market of the 1980's was due primarily, in my opinion, to the fact that new buyers came to the market who did not have to price their securities daily. As long as thrift and insurance organizations could buy low credit rated bonds on a coupon basis, there was no discipline to their activities in terms of the risks they were undertaking. While some mutual funds did buy some bonds of questionable value they knew that they had to meet daily redemptions. Therefore, I would guess that their portfolios were in higher quality paper than other institutions investing in the same general category of securities.

Sincerely,

A. Michael Lipper, C.F.A.
President

AML/jcp
cc: Mr. John H. Gutfreund
Mr. Philip J. Purcell
Mr. W. Lucas Simons, Jr.
Mr. Robert Downey
Mr. Samuel L. Hayes

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM

Philip J. Purcell

DEAN WITTER FINANCIAL SERVICES GROUP INC.
TWO WORLD TRADE CENTER, 66TH FLOOR
NEW YORK, NEW YORK 10048

PHILIP J. PURCELL
Chairman and
Chief Executive Officer

May 31, 1990

(Responses to questions
posed by Sen. Terry
Sanford)

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510-5075

Dear Chairman Riegle:

Dean Witter Reynolds Inc. ("Dean Witter") is pleased to respond to your letter dated March 13, 1990 to me in which you asked Dean Witter to respond for the record to three questions raised during the hearings held by the Securities Subcommittee of the Senate Banking, Housing, and Urban Affairs Committee on March 6, 1990. We again express our appreciation for inviting us to testify on the current state of the securities industry.

Our responses to specific questions follow.

Q.1. As you know, last week along with the Senators Sasser and Ford, I introduced legislation, S. 2160, concerning corporate takeovers and leveraged buyouts and the short-term focus of many of our corporate managers and institutional investors.

One of the issues that the bill tries to address is that of the short-term trading strategies of many of our institutional investors. Indeed, some pension funds have been reported as having turnover rates as high as thousands a percent a year, with the averages being 60-70% turnover rates.

A number of different suggestions have been made for addressing the issue. Senators Kassebaum and Dole have proposed a tax being greater on shares held for even shorter periods than 6 months.

In our bill, S. 2160, we suggest a different approach--applying the "short-short" rule that currently applies to mutual funds to pension funds as well. The short-short rule prohibits a mutual fund from making more than

30% of its income from shares held for less than three months. Our bill would prohibit pension funds from deriving more than 30% of their gross income from the purchase and sale of shares held for less than 3 months.

We included this provision to promote discussion of the issues surrounding churning or high-turnover rates by institutional investors and the short-term focus of many large corporations.

I would like your comments on this proposal. Will it help address the problem of churning? Is 30% of income from shares held for less than 3 months the right place to draw the line? Is using tax incentives a better way to address the problem?

A.1. As you know, in our written submission to the Subcommittee, Dean Witter recommended that investors such as pension funds enjoying tax exempt status be discouraged from using their status for excessive short-term profits. We urged Congress to consider initiatives to encourage tax exempt organizations to use long-term investment strategies and discourage the use of short-term trading strategies that may heighten volatility, destabilize the markets and pressure corporate management to emphasize short-term profitability as opposed to longer term planning, investment and research. In my testimony, I recommended that Congress consider the "short-short term capital gains" rule now governing mutual funds for pension funds. The short-short gain rule applicable to mutual funds would provide flexibility in managing pension fund assets while also serving as a restraint on pension fund managers' excessive short term trading. We believe that the short-short term capital gains rule has discouraged portfolio managers of mutual funds from engaging in excessive short term trading.

Dean Witter believes that such an approach applied to investors enjoying a tax exempt status would represent an important public policy initiative designed to discourage extensive or excessive short-term trading. We agree with the concern expressed in the question that hostile corporate takeovers and other transactions have, to some extent, caused corporate managements to focus on short-term, rather than long-term, strategies and objectives. We also agree with the concerns expressed about excessive short term trading by persons focusing on temporary pricing inefficiencies in the cash and futures markets. We refer to such traders as "one minute shareholders" because they are indifferent to the long-term performance of the securities they purchase and the underlying issuer's preference for balanced long-term, rather than erratic short-term, growth. We are concerned that such a focus has resulted in a decrease in research and development and other important corporate expenditures that are critical for America to continue to be the leader in the worldwide economic environment.

Dean Witter urges, therefore, the Senate to carefully consider Section 7 of S. 2160. The Senate should consider the views of pension managers and others on this issue. We encourage Congress to consider a proposal which encourages pension fund managers to invest with a long-term perspective but avoid a penalty or direct tax on pension participants.

Q.2. Another one of the provisions of S. 2160 would require an independent fairness opinion of the value of an LBO. The bill requires that any directors, employees or affiliates intending to purchase all or substantially all of the shares of a corporation must obtain an appraisal from a nationally accredited accounting firm which has no financial interest in and whose fees for performing the appraisal are not related to the outcome of the transaction. This appraisal would be made available to the board and shareholders at least 20 days before the acquisition occurs.

Is it possible to obtain an "independent" appraisal of the fairness of a leveraged buyout offer? Is this approach likely to help disclose more of the facts surrounding LBOs so that the conflicts management faces are lessened?

A.2. Dean Witter shares the concerns of the authors of S. 2160 concerning the conflicts of interest which exist between directors, employees, or affiliates of public companies proposing to purchase all or substantially all of the shares of their companies in a management led leveraged buyout ("Management LBO") and the unaffiliated public shareholders of companies faced with a Management LBO. The conflict is clear. On the one hand, corporate managers recognize their obligation to maximize values to all shareholders. On the other hand, the goal of the proponents of a Management LBO is to take the company private at a price at which the proponents believe they will be able to realize a return commensurate with the risks associated with such a transaction. A management group offering to purchase its company often has a better insight as to the true "value" of the company than unaffiliated potential bidders for the company.

Dean Witter respectfully suggests two elements are important to protecting unaffiliated public shareholders in a Management LBO -- full disclosure on the transaction and high quality advice to those individuals who must take the responsibility to protect shareholders. First, the proponents must comply with the comprehensive disclosure requirements of the Securities and Exchange Act and rules regarding going private transactions (SEC Rule 13e-3). A second key element is the presence of a well advised independent committee of the board. Independent committees should play a critical role in evaluating any Management LBO and protecting the interests of the public shareholders.

Dean Witter does not agree, however, with that provision of S. 2160 which would require a target company in a Management LBO to obtain an appraisal from a nationally accredited accounting firm.

It is unclear to us whether the appraisal required by the Bill is a substitute for the financial advice otherwise given to the company. Typically, an investment bank represents the company (the independent committee of the Board) in negotiations between the bidder (the management group), also represented by an investment banker, and the company. It is unclear whether S. 2160 would require the company (through the proponents of the Management LBO) to obtain an accountant's appraisal in addition to the advice/opinion the independent committee may obtain from its investment bankers.

We believe that any appraisal by an accounting firm is not a substitute for the financial advice provided by the independent committee's investment bankers. The particular expertise of public accountants is to account for and opine on the presentation of a company's balance sheet, income statement, and other items, all of which relate to a company's history and not to its prospects for growth in the future or to the present value of projected future income streams or the value which might be placed on the company by the market. The expertise and experience on the qualitative and quantitative valuations necessary to advise an independent committee of a board of directors when faced with a Management LBO resides in the investment banking community. We believe it would place the independent committee of a board of directors at a competitive disadvantage if, on the one hand, a management led group receives financial advice on the value of the subject company from an investment banking firm specializing in the valuation of securities and securities markets and, on the other hand, the independent committee (and indirectly the public shareholders) only receives an appraisal and advice from an accounting firm.

The special capabilities of investment banks in this area are not based upon accounting valuation methods and models, rather it is based mostly upon their ever continuing knowledge of buyers and sellers of companies and securities which arise from the investment banks' daily activities. This is not an area in which accounting firms are active or experienced. Dean Witter, while acknowledging its self interest on the issue, believes that investment bankers which are expert in the valuation of securities are critical to an independent committee of the board representing the interests of the public shareholders in a Management LBO.

In response to your question whether the presence of an independent accounting firm would result in enhanced disclosures to shareholders, Dean Witter believes that such a requirement would not result in enhanced disclosures regarding Management LBOs. Securities and Exchange Act Rule 13e-3, dealing with "going private" transactions, currently requires that proponents of such transactions comply with extensive disclosure requirements in the filing of their Schedule 13e-3. Dean Witter urges the Committee to consult with the Commission and obtain its view regarding the possibility of requiring additional disclosure of the conflicts of interest present in such transactions.

Another issue identified in your letter is whether the contingent nature of investment bankers' fees in leveraged buyout--fees dependent upon a transaction closing--causes any policy problems. The issue would be that investment bankers have economic incentives towards assuring that transactions close.

Dean Witter agrees that in some circumstances, contingent fees create a conflict between the work of an investment baker in advising a special committee to obtain the best possible price and the possibility that if the transactions fails to close, their fees will be reduced.

In our opinion, this is caused by a variety of reasons including 1) the influence of management, 2) the legitimacy of the bid, 3) inexperience by Directors, etc. However, fees' structures are extremely difficult to legislate. We believe that the key issue is that the independent Committee have available advisors of equal or better quality, motivated to protect shareholders. This includes legal advisors, investment bankers, accountants, industry consultants, etc. With the assistance of counsel and other sources of advice, an independent Committee should be able to work out a fee agreement which is appropriate for the circumstances. That Committee should not be constrained by management in pursuing high quality advice. Dean Witter has given several unfairness opinions, and the fee agreements were different in each case. From our perspective, unfairness stems more from having lesser amounts and lesser quality resources available to independent Committees versus well-motivated, well-informed advisors for the Management buying groups.

One way to address this potential conflict is for the agreement between the independent committee and their advisor to provide that the investment banker's fees are payable when they are prepared to deliver a fairness opinion, and not when the relevant transaction closes. This might reduce the conflict identified above.

Dean Witter suggests that the Committee consider two ideas on the subject of conflicts and Management LBOs:

> (i) require companies with equity securities registered under the Exchange Act faced with a "going private" bid from a management group to form an independent committee of the board to evaluate such offer; and
> (ii) require a management group proposing an LBO, out of their own financial resources, to pay a percentage of the fees incurred by the company when it evaluates and responds to the bid by a management group.

The first idea is consistent with our views regarding the importance of independent committees. Most boards of directors, in our experience, do form such a committee when confronted with a Management LBO. The independent committee plays a critical role in maximizing values to the unaffiliated shareholders. The second idea, compelling management to pay a percentage of the fees incurred by the company relating to management's offer, is designed to discourage "lowball" bids and to prevent the insulation of management bidders from costs associated with their proposal. Some of the target company's costs associated with the Management LBO should be paid from a source other than its own resources. Such a requirement might also improve public perceptions on the fairness of Management LBOs because bids by management would not be without economic risks to their proponents.

Q.3. **Much has been said that with the fall of Drexel and the downturn in the junk bond market, that the highly leveraged, break-up type takeovers and LBOs are a thing of the past. In my opening statement, I commented on the remarks of Jerome Kohlberg concerning excesses of the 1980s, including primarily**

excessive fees as part of these deals, and tremendous conflicts of interest on the part of management, banks and investment banks.

Do you agree with Mr. Kohlberg that excesses with respect to fees and conflicts of interest occurred during the 1980s? If so, despite the downturn in the junk bond market, is there anything to prevent those excesses from occurring in the future?

A.3. Dean Witter agrees that certain excesses may have occurred with respect to fees and conflicts of interest in the 1980s. We believe such excesses resulted, to a large extent, because a single firm possessed an overwhelming market share of the high yield market. Market dominance existed both for originations and for secondary market trading.

We believe, however, that extensive and intense competition now exists with respect to the origination, placement and sale, and secondary market trading for high yield bonds issued in Management LBOs. Commercial banks, investment banks, and potential bidders all have learned from the failed deals of the 1980s, and are now more circumspect before committing capital. The mistakes of market participants coupled with the current competitive environment have reduced the excesses of the 1980s.

Dean Witter again thanks you, Mr. Chairman, for inviting us to participate in your important hearings and study on the state of the securities industry. We urge you, the members of your Committee, and your respective staffs to continue your work on this subject. We offer our assistance in this important work.

Cordially,

Phil Purcell

Philip J. Purcell